JESSICA

JOINT EUROPEAN SUPPORT FOR SUSTAINABLE INVESTMENT IN CITY AREAS

UDF Handbook

HORIZONTAL STUDY

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FOREWORD

This handbook seeks to provide Managing Authorities and other JESSICA stakeholders with good practice principles and guidance for the establishment, operation and wind-down of JESSICA Urban Development Funds (UDFs).

It takes over from the 'Holding Fund Handbook' at the point a Managing Authority has taken the decision to implement a JESSICA Operation and from the 'UDF Typologies and Governance Structures' study (referred to hereafter as 'the UDF Typologies Study') that helps determine a suitable UDF structure to be adopted.

The use of financial instruments established under Article 44b of the General Regulation continues to evolve as stakeholders bring fresh and innovative thinking in response to changing market and fiscal conditions across all constituencies of the EU. This evolution requires the development of new provisions such as "COCOF Note 3" (see glossary). The evolution so far allows this handbook to be seen as a current expression of views on good practice which can be built on in the future. It is therefore not designed to guarantee the readers' compliance with all EU regulations or other relevant provisions at EU-level (for example that concerning State Aid).

At the time of writing, JESSICA financial instruments continue to be taken up right across the EU through Holding Fund (HF) and non-Holding Fund routes. At end-2011, 46 JESSICA Financial Engineering Instrument had been mandated to manage €1.53bn, with a number of UDFs still in the pipeline.

In practice, UDFs are emerging as varied instruments. Some key characteristics are listed as follows:

- Size ranging from around €10m;
- The financial products currently provided are mainly Loans but with some Equity in certain cases[1];
- Sectors targeted have so far included urban redevelopment, commercial office development and energy efficiency;
- UDFs are being appointed and operated by a range of public entities, private entities, and public/private entities.

The regulations leave flexibility for UDFs to be established in a manner that best fits local needs and priorities. However, each UDF must conform to a set of common principles (that this handbook intends to describe). These principles are defined through a combination of EU regulations, local laws and established good practice seeking to respond to bespoke market conditions.

This handbook loosely follows the 'lifecycle' of a UDF, covering:

[1] As it appears that there are no examples so far of UDFs providing guarantees, the document does not cover this issue in detail. The provision of guarantees by a UDF will probably require some in-depth study in the first instance and should be treated by way of a targeted piece of work before including related guidance.

- Preliminary steps - The key stages for determining the strategy and remit of a UDF in response to the Operational Programme (and Priority Axes) from which the resources originate. This should include developing a UDF Investment Strategy to fit with the objectives of the MA's own strategy. The chapter also reviews issues faced in the selection and appointment of a UDF, not least the implication of whether or not the UDF provides or receives 'State-aid';

- Pre investment processes – Including the development of a UDF's Business Plan for approval by the HF/MA and the necessary processes for establishing its governance, culminating in the contractual agreement to appoint the UDF. This section will also explore how a UDF may undertake the selection of suitable Urban Projects for investment;

- Investment processes – Showing how UDF Fund Managers might approach investing UDF resources into Urban Projects once they have been selected as suitable investment opportunities for the UDF, and further how a UDF might go about managing those investments during their lifecycle;

- Post investment processes – Providing guidance on how the UDF should undertake its role in the monitoring, management verifications, reporting and auditing necessary for ERDF Operational Programmes; and

- Horizontal Themes – Dealing with issues such as irregularities arising in JESSICA Operations and providing guidance on management costs and publicity, thus addressing some of the wider requirements upon UDFs in meeting EU regulations.

CONTENTS

1. PRELIMINARY STEPS

This section sets out key considerations to be taken into account prior to the approval of a JESSICA Operation within a Member State and the subsequent establishment of UDFs.

This section is relevant not only to Managing Authorities but also to a potential UDF Fund Manager as the outcomes of this stage will shape the scale and focus of the UDF(s) to be created. UDF Fund Managers will need to ensure that the UDF investments into Urban Projects reflect the eligibility, scale and priorities set within Operational Programmes from which resources are drawn for deployment via JESSICA Operations.

These preliminary steps are key stages in determining the feasibility of establishing a JESSICA Operation within a particular territory and the associated Investment Strategy required to ensure that a UDF delivers in line with the objectives of the OP resources entrusted to it. This section provides guidance on how to:

- Evaluate the feasibility for JESSICA Operations given the OP and conditions specific to the territory to be supported by FEIs.
- Formulate an appropriate Investment Strategy for the HF (or to the extent applicable, the MA) and the UDF(s).
- Identify and understand the potential sources of National Co-financing and Co-Investment.
- Develop a governance structure for UDFs (and appropriately define the role of the UDF within this structure).
- Define the process by which a UDF is to be procured, in compliance with EU and national procurement rules.
- Identify if action is required to bring the JESSICA Operations in line with State Aid provisions.

Each of these preliminary steps is considered below. Where a Holding Fund (HF) is to be deployed as part of the JESSICA Operation, the HF Handbook is relevant and is referenced throughout this section. Where this section covers some of the areas set out in the HF Handbook (namely JESSICA Evaluation Studies and HF/MA Investment Strategy), this document focuses on the relevance from the perspective of the UDF Fund Manager (rather than the HF Fund Manager). More specifically, this means upstream and downstream contractual relationships with the UDF, providing additional operational and legal detail provided, where appropriate.

1.1 JESSICA Evaluation Study

It is necessary to evaluate the need for a JESSICA Operation within a given territory, and establish the feasibility of creating one or more FEIs – this is a key stage in the normal decision–

making process for establishing the UDF(s)[2]. The JESSICA Evaluation Study sets out the rationale for adopting FEIs and should ideally:

- Identify and demonstrate relevant market gaps (or market failures);
- Describe the benefits of using a JESSICA Operation to address these gaps;
- Identify potential demand for UDF investment and identify possible key stakeholders;
- Identify structural options (such as the use of a HF and the number and type of UDFs to be established) and actions required by the MA for implementing FEIs;
- Provide the framework for the development of the Investment Strategy for HFs and UDFs;
- Identify a pipeline of likely Urban Projects and illustrate case study Urban Projects serving as examples for the implementation of UDFs in the territory under study.

The feasibility work will typically represent the initial business case for the establishment of JESSICA Operations at a national or regional level. It provides the rationale for the establishment of the selected JESSICA Operation from a policy, strategic and market context, and outlines the benefits it can deliver. This will inform the detailed investment strategies for the HM/MA and UDF(s) (*Sections 1.2 and 1.3*). For instance, a JESSICA Evaluation Study can provide the HF/MA and UDFs with evidence of the demand for a JESSICA Operation in a local market, as well as inform the nature of investment product that should be provided through the use of FEIs, the preferred delivery model to inform the scale of the FEIs, the possible sources of National Co-financing and the likely eligibility focus of the FEIs.

The JESSICA Evaluation Study also serves to support Article 43(3) of the Implementing Regulation which requires that business cases need to be submitted by FEIs. A Business Plan can serve as justification for the intended contribution from the Structural Funds to FEIs and the preparation of such a Business Plan can be informed by the JESSICA Evaluation Study.

Since the contents of the JESSICA Evaluation Study are very likely to shape the Investment Strategy for the HF/MA and the UDFs, it is important that a prospective UDF Fund Manager ensures that the UDF's Business Plan is aligned to the broader objectives of the proposed JESSICA Operation. Those broader objectives are normally set out on the basis of an approved JESSICA Evaluation Study. It will be important for the UDF Fund Manager to also take into account feedback from local authorities, the MA, the HF (if applicable) and DG-REGIO on these strategies and plans.
The following sub-sections outline relevant elements within the JESSICA Evaluation Study that MAs, HFs and UDF Fund Managers should refer to when developing UDF Business Plans.

Further detail on JESSICA Evaluation Studies is provided in section 2.1 of the Holding Fund Handbook.

[2] Certain Managing Authorities do not require feasibility studies to be undertaken due to JESSICA Operations being specifically mentioned as part of their original plans for the delivery of Operational Programme outputs. On the other hand, some Operational Programmes state that JESSICA Operations are permitted, but assume a feasibility study will be used to justify setting up UDFs at some point during the programming Period.

1.1.1 Policy & Strategic Fit

The JESSICA Evaluation Study will seek to identify how a specific JESSICA Operation can support relevant European, national and regional strategic and/or spatial priorities targeting UDF Investments on identified areas of market failure. Potential UDFs and Urban Projects will be assessed on their ability to support these priorities.

At a very basic level MAs will need to ensure that any JESSICA Operation utilising Structural Funds is consistent with the applicable Operational Programme (OP) and Priority Axes for the territory in question. Article 9 of the General Regulation states at paragraph 2 that: *"The Commission and Member States shall ensure that assistance from the Funds is consistent with the activities, policies and priorities of the Community and complementary to other financial instruments of the Community. This consistency and complementarity shall be indicated in particular in the Community strategic guidelines on cohesion, in National Strategic Reference Frameworks and in the Operational Programmes".*

MAs must therefore also ensure that a JESSICA Operation will operate in a manner consistent with the principles set out in the applicable National Strategic Reference Framework (the "NRSF") and in all cases operate in conformity with the provisions of the Treaty on the Functioning of the European Union ("the TFEU"). Article 9 of the General Regulation expressly states at paragraph 5 that: *"Operations financed by the Funds shall comply with the provisions of the Treaty and of acts adopting it".* This includes, but is not limited to State Aid Rules and the obligations relating to fairness and transparency.

The operation of the UDF, its Business Plan and the Investment Strategy it will operate under, must also be structured so that they are consistent with the requirement for final recipients to be part of an Integrated Plan for Sustainable Urban Development ("IPSUD"). Article 46 of the Implementing Regulation states that: *"Where Structural Funds finances a UDF, those funds shall invest in public private partnerships or other projects included in an integrated plan for sustainable urban development"*[3]. The UDF's Investment Strategy will therefore need to be closely aligned to both the IPSUD and OP priorities in order to ensure that investments are strategically directed by both policy and spatial planning considerations.

1.1.2 Assessment of Demand

The key 'driver' or rationale for using FEIs should be based on establishing the scale and source of demand for investment support. This means the feasibility work should identify the precise need (or needs) for the establishment of FEIs supporting investment in sustainable urban transformation in order to then enable investment by UDFs into Urban Projects to be strategically focused. In other words, market segments should be identified where market failures or sub-optimal investment situations exist. The demand assessment establishing the scope for possible UDF intervention should be aligned with the requirements of the NSRF and the OP as referred to in paragraphs 1.1 and 1.1.1 above.

[3] The UDF Fund Manager should also review the nature of the IPSUD from the perspective of EU Commission State-aid provisions. As is further explained in chapter 1.5, the IPSUD may indicate whether or not aid can to be provided by the UDF when delivering projects aligned to the plan. It should be noted that most IPSUD projects are typically designed to be delivered with grant support, which is usually covered from a State-aid perspective via the GBER. However, as JESSICA Operations do not fall under the GBER, the UDF may be able to anticipate whether or not a notification of the Operation is required based on the likely type of project investments the UDF will be making under prevailing IPSUDs.

The identified market finance gap should ideally describe in detail the market failure for the provision of equity and/or debt financing for Urban Projects. For instance, this might involve the existing lack of investment from commercial sources for specific market segments. To document the existence of the market gap, the JESSICA Evaluation Study should ideally include evidence on the level of demand resulting from the identified market failure. In this context, the evidence of demand for UDF investment might include a pipeline of Urban Projects that generate the socio economic outputs targeted by OPs under consideration as part of the study.

The reasons behind market failure are often unique to each region and market segment, however, and they broadly fall into one of the following categories:

- **Profitability gaps** – For example where the likely payback period on an investment is not competitive within the local market
- **Externalities –** For example where the success of the Urban Project is dependent upon unprofitable components that the local market fails to address such as land assembly, site decontamination, provision of basic infrastructure, etc.
- **Strategic investment** – For example where there may only be a case for investment in an Urban Project if it is part of a wider portfolio of investments or where the local market has been stimulated by Pump-Priming (where public money has been invested in an area in order to create favourable conditions for private sector investment and thus stimulate the economy)
- **Member State economic constraints –** For example where Member States have prioritised fiscal tightening above spending on its economic development agenda (such as for deficit reduction reasons), but where Urban Projects containing Eligible Expenditure still exist and require funding.

The level of demand can be outlined by providing an initial evidence base of Urban Projects containing Eligible Expenditure that could represent investment opportunities for a UDF. The JESSICA Evaluation Study will need to define a sufficient indicative pipeline of deliverable Urban Projects containing an adequate level of Eligible Expenditure to justify the creation of a UDF (or UDFs) of a certain size. The study should also as demonstrate the benefits and outputs from final recipients which would support the objectives of the OP from which the resources are to be drawn.

Accessing Past Experience: Evaluation and Horizontal Studies in Support of JESSICA

The European Investment Bank, through its collaboration with the European Commission, has commissioned a series of JESSICA Evaluation Studies at the request of Managing Authorities of Member States or regions. A JESSICA Evaluation Study typically comprises an analysis of the market gap for FEIs in support of sustainable urban development in a region (or regions)of the European Union supported by EU Structural Funds for the period 2007-2013 and explores the options for the use of Holding Funds and UDFs in the implementation of JESSICA Operations.

In addition, the European Investment Bank has commissioned a number of Horizontal Studies (of which this report is one) that are relevant for the development of JESSICA Operations and are also an important tool to assist Member States and regions prior to and/or during implementation of the JESSICA initiative. Such studies provide guidance on operational matters relevant to stakeholders in all Member States, based on recent experience.

Study reports are available on the EIB web site at:

http://www.eib.org/products/jessica/studies/evaluation.htm

The evidence base for demand need not equate to a full investment appraisal that a UDF would be expected to carry out on Urban Projects (see Chapter 2, Section 2.2). The evidence should, however, while not anticipating a later selection procedure, provide a robust sample of potential final recipients, an assessment of the potential scale of the demand for UDF investment, and suggest the possible investment role for a UDF in those target final recipients. The afore-mentioned assessment of demand for UDF investment that should be detailed within the JESSICA Evaluation Study will be informed by a review of potential final recipients (across the public and/or private sectors) which are expected to be 'investment ready' before the end of 2015. In addition to assessing the amount of Eligible Expenditure contained in the pipeline of Urban Projects, the JESSICA Evaluation Study should:

- Demonstrate the revenue generating potential of the Urban Projects to support the development of a UDF investment pipeline;

- Highlight the presence of ineligible expenditure in Urban Projects. While UDFs can only use their OP resources to finance Eligible Expenditure within an Urban Project, Co-Investment resources the UDF has at its disposal could be used to support other components of the same Urban Projects[4];

- Ensure that the potential final recipients are expected to be ready to receive investment within the timeframes of the OP, since UDF investment into final recipients must be committed and incurred by the specified cut-off date for Eligible Expenditure.

The demand assessment could also identify which, if any, existing entities are capable of taking the role of UDF and further identity the applicable national and EU procurement rules associated with the appointment of such an entity as UDF (see also section 1.7 below).

1.1.3 Availability of ERDF resources, National Co-financing and Co-Investment

The JESSICA Evaluation Study should take into account the following as this will impact upon the size of any eventual JESSICA Operation:

- Levels of ERDF commitments and disbursements made so far under each OP.

- Levels of available public and/or private National Co-financing, including whether they can be provided at FEI or Final Recipient Level.

- Sources and levels of Co-Investment.

4 It is noteworthy that Article 43(6) of the Implementing Regulation states that Urban Projects may receive both ERDF grant funding and FEI support.

The box below illustrates a case study concerning the provision of National Co-financing:

National Co-financing requirements in the UK and associated implications on the drawdown of ERDF resources

In the UK, National Co-financing is not usually provided at central government level, but is required from regional governments within whose jurisdiction an Operation is to be set up. The national rules require National Co-financing to be committed to UDF prior to the transfer of ERDF resources into a UDF. The source and timing of the National Co-financing could vary depending on the type of JESSICA Operation:

- Where there is no HF within a JESSICA Operation, this would require upfront National Co-financing being provided by the UDF from its partners or investors or provided by the public authorities (in this case usually the regional government);

- Where there is a HF, UDF selection criteria could be defined such that candidate UDFs are assessed on their ability to provide substitute National Co-financing to replace any initial contributions already provided by the MA and its partners at HF level in order to drawn down ERDF resources into the HF before the UDF is created.

As a result, a key element in assessing the suitability of a vehicle/entities seeking to operate as a UDF in the UK is often the ability of the UDF to provide resources that could be used as National Co-financing as well as other resources to be used for Co-Investment.

1.1.4 Preliminary Financial Analysis

The JESSICA Evaluation Study should include an indicative financial analysis for the proposed FEIs. This can be informed by the nature and timescales of an identified pipeline of Urban Projects, and the potential scale of JESSICA Operations within a region. Drawing on assumptions concerning level, timing and performance of investments to be made, such an analysis will be illustrative at this early stage, but serves to:

- Reflect the emerging findings of the study indicating the level of demand for UDF investment as thus informing the indicative scale of FEIs being proposed;

- Present envisaged costs, revenues and Income Receipts for the proposed FEIs.

- Illustrate aspects of the JESSICA Operation which may be subject to further scrutiny concerning the presence (and if so compatibility) of State Aid.

Any such preliminary initial financial analysis for proposed FEIs would, in all cases, need to consider its consistency with the requirements of the NRSF, OP and IPSUDs. It should be noted it is possible to invest in projects where not all of the expenditure is regarded as Eligible Expenditure, subject to there being in place mechanisms to clearly identify OP resources invested as Eligible Expenditure as being distinct from ineligible items of expenditure. In other words, a clear audit trail will be necessary to demonstrate this [5].

[6] Article 93 of the General Regulation relates to the principles under which the Commission will automatically decommit any part of a budget commitment in an Operational Programme that has not been used by either the second or third year (depending on the member state in question) following the year of the annual budget commitment described under the OP.

In addition to costs and revenues to be envisaged at Final Recipient level, the financial analysis should also provide initial estimates of Management Costs and and/or Management Fees. These will need to be consistent with Eligible Expenditure requirements under Article 78(6) of the General Regulation and Article 43(4) of the Implementing Regulation which refers to the eligibility of Management Costs and Management Fees and specify limits to avoid overcompensation. See *Section 5 on eligible Management Costs and Management Fees.*

The UDF Investment Strategy should reflect the findings of the financial analysis from the JESSICA Evaluation Study, or other more detailed and up-to-date financial analyses that are carried out. In doing so, this will establish MA, HF, UDF and other Shareholder expectations of fund performance, including the level and timing of Capital Receipts and Income Receipts.

1.1.5 Structuring and selection of FEIs within a JESSICA Operation

Each MA has flexibility to find pragmatic solutions to structure FEIs within a JESSICA Operation in order to reflect local market conditions and respond to requirements of stakeholders involved.

This is set out in COCOF Note 3, which refers to two scenarios where some MAs establish HFs while others do not.

The JESSICA Evaluation Study may suggest options for the structuring of a JESSICA Operation and associated governance arrangements. This should include the rationale for utilising or not utilising a HF. The JESSICA Evaluation Study should further outline the number and type of UDF(s) to be set up.

The MA will ultimately decide the appropriate structure for the implementation of a JESSICA Operation, thus informing the remit and number of UDFs. The rationale for the use of a Holding Fund is outlined in the Holding Fund Handbook (p.14-15) along with the relative pros and cons of implementing JESSICA Operations with and without an HF (p.23-29).

When considering options for the structuring of UDFs, the following considerations are likely to be assessed at the evaluation / feasibility stage:

- Investment Focus of proposed UDFs (for instance: geographic remit, sectoral remit, thematic, focus, etc.);
- Number and Fund size of proposed UDFs (to reflect the scale and focus of the envisaged investments in the region).

The 'UDF Typologies Study' provides further detail on the type of UDFs that could be developed.

[5] See question 13 in the Annex of COCOF 08/0002/03 – Guidance Note on Financial Engineering.

[8] For example all UDFs procured by Holding Funds operated by the European Investment Bank are selected using the Bank's own internal procurement rules (as permitted by EU legislation governing the Bank since it is a European Institution established under the Treaty.

1.2 Formulation of the HF/MA Investment Strategy

The Investment Strategy established at MA or HF level represents an important step in the definition of a JESSICA Operation for a Member State region or city area. The Investment Strategy should set out an investment plan and targets that should reflect the policies, objectives and priorities identified in the JESSICA Evaluation Study. It should provide financial and commercial direction on the type and source of potential investments; and should provide detail on:

- Urban and spatial policy relevant to the geography which is to be supported by the JESSICA Operation. Specific reference may be made to urban planning structures that will be relied upon to help define the strategic focus of the funding and to help satisfy the IPSUD requirements;

- OP objectives – should be described how investments made under the JESSICA Operation will be on-line with Priority Axis (or Axes) from which the OP resources are to be drawn;

- Possible structuring of the JESSICA Operation;

- Likely suite of financial products to be provided (Senior Loans, Mezzanine Loans Quasi-Equity, Equity and/or Guarantees);

- Likely, focus of underlying UDF investment - the HF/MA Investment Strategy may also start to define key criteria to assist the UDF in identifying appropriate Urban Projects for investment.

The HM/MA investment strategy will therefore shape the focus of a JESSICA Operation within a Member State or region at a macro level. This in turn will inform the UDF Investment Strategy. Needless to say, the HF/MA Investment Strategy will need to be compliant with the requirements of the TFEU and EU regulations, including that concerning the provision of State Aid.

1.3 Formulation of the UDF Investment Strategy

The UDF Investment Strategy is a key component of the Level II Funding Agreement.

It will normally be based upon the Business Plan presented by the candidate UDF at the time of UDF selection. The UDF Investment Strategy will therefore influence heavily the actual Business Plan of the UDF during its lifecycle.

The UDF Investment Strategy should be in line with the HF/MA Investment Strategy.

1.3.1 Suggested outline of a UDF Investment Strategy

Typical content of a UDF Investment Strategy and/or the proposed Business Plan of a candidate UDF is outlined below:

(a) description of the target market of Urban Projects (including any geographic and sectorial delineations) and the criteria (eventually terms and conditions) to be applied for financing and evaluating them. This should be aligned with the National Strategic Reference Framework and should include the envisaged financial products (Loan, Equity and/or Guarantee) to be provided by the UDF;

(b) operational budget and financial projections of the UDF, including financial modelling to demonstrate sensitivity to funding, financing and asset performance scenarios. This should take into account the number and scale of final recipients envisaged and proposed terms of investment by the UDF (e.g. seniority, co-investment with preferential returns, etc.);

(c) ownership of UDF;

(d) details of all co-financing partners and shareholders;

(e) by-laws of the UDF;

(f) provisions on professionalism, competence and independence of the UDF fund management;

(g) justification for, and intended use of, the OP resources to be entrusted to the UDF. This would include the alignment of support to be provided by the UDF (in using OP resources) with the Priority Axes from which the OP resources have been contributed to the UDF. The envisaged contribution by the UDF to the delivery of OP output targets may also be indicated. In addition, relevant existing planning structures may be identified which both could assist already identified projects to satisfy the IPSUD requirement and assist in the identification of additional Urban Projects;

(h) policy of the UDF concerning exit from investments in Urban Projects;

(i) winding-up provisions of the UDF, including its approach (if applicable) to Follow-on Investments or further reutilisation of resources returned to the UDF from investments, or left over after all guarantees have been honoured, attributable to the contribution from the OP.

The UDF Investment Strategy should be assessed, and its implementation monitored by, the HF or MA or other competent body delegated by the HF or MA. The member state should further ensure that the UDF Investment Strategy complies with rules on the provision of State Aid.

The following sub-sections elaborate further on components of the UDF Investment Strategy described above.

1.3.2 Target Market for UDF Investment

The UDF Investment Strategy should be aligned to the areas of market failure set out in feasibility work undertaken (including the JESSICA Evaluation Study as may be appropriate). It should include the focus of investments by geography specific urban area (as be appropriate) and by sector or thematic area. The UDF Investment Strategy should also present evidence of Urban Project demand for investment, and include details of Urban Projects that have been identified already as eligible for investment.

In order to establish such an initial list of Urban Projects, the UDF Fund Manager will probably need to undertake soft market testing of public and private sector organisations operating envisaged across the target market in order to identify and assess the potential initial pipeline of Urban Projects. The UDF would normally contact directly the managers or promoters of

Urban Project and related stakeholders to best understand the characteristics of the Urban project, including outputs or non-financial benefits to be generated by the Urban Project, the extent of the need for UDF support and the potential terms of investment, that may eventually be deemed as acceptable to the Urban project.

The resulting list of potential Urban Projects should help to evidence the demand for UDF investment as outlined initially in the JESSICA Evaluation Study and assist in defining the Business Plan of the UDF by:

- Collecting further and updated detail on the Urban Projects already identified. This may include for instance more information on the Urban Project's funding mix; the type, scale, timing of investment, outputs and non-financial benefits to be generated by the Urban Project; and the level and timing of expected Income Receipts and Capital Receipts to the UDF;

- Identifying additional Urban Projects eligible for investment that were not cited in the earlier feasibility work;

- Prioritising Urban Projects for UDF investment, based on criteria, agreed with the HF/MA understanding any opportunities for project partners to contribute cash or land assets that may be relied as potential to enable draw down ERDF resources).

When investing in line with rules for Eligible Expenditure, UDFs will also need to operate within national eligibility rules within the applicable Member State (as referred to in Article 56(4) of the General Regulation). Such rules may, in some cases, apply over and above those expressly referred to in the Structural Fund regulations[6]. For example, in England the use of ERDF is subject to the national eligibility rules as set out by the UK Managing Authority. This includes a restriction on using ERDF to support retail facilities.

Care should also be taken around sector restrictions that relate to the use of ERDF and ESF resources. These include a prohibition on using these resources in support of the following;

- Fishery and aquaculture sectors which are supported through the European Fisheries Fund (EFF);

- Primary production, processing and marketing of agricultural products, which is supported through the European Agricultural Fund for Rural Development (EAFRD);

- The coal, steel and shipbuilding sectors (excluded by the General Block Exemption EC 800/2008);

- The synthetic fibres sector (excluded by the General Block Exemption EC 800/2008).

- Companies in difficulties[7].

[6] Article 56(4) of the General Regulation states that *"the rules on eligibility of expenditure shall be laid down at national level subject to the exceptions provided in the specific Regulations for each Fund".*

[7] The normal provisions for this are set out in the Community Guidelines on State Aid for "Rescuing and restructuring of firms in difficulty" (OJ 244, 01/10/2004 pages 0002-0017) which have been extended to 9 October 2012 (in respect of large enterprises) and Article 1.7 of the Commission Regulation (EC) No 800/2008 of 6 August

Article 46 of Implementing Regulation also states:

"Where Structural Funds finance urban development funds, those funds shall invest in public-private partnerships or other Urban Projects included in an integrated plan for sustainable urban development. Such public-private partnerships or other Urban Projects shall not include the creation and development of Financial Engineering Instrument such as venture capital, loan and guarantee fund for enterprises."

In practice it is unlikely that an investment by a UDF in an Urban Project would stray into such investments, but it is advisable to ensure that UDF Fund Managers are made fully aware of these restrictions (with the details incorporated within the applicable Level II Funding Agreement).

Urban Project Selection

At a practical level, HF/MA Investment Strategy and UDF Investment Strategy will imply a series of criteria that must be met by Urban Projects to be considered as suitable investment opportunities for a UDF. As will be covered in chapter 2.2 the UDF is responsible for setting out a structured, clear and transparent process for selecting Urban Projects for investment. As part of that process, it may be necessary to establish an initial shortlist of Urban Project opportunities to allow the UDF to focus more detailed effort on likely Urban Project investment candidates.

The following is provided as possible short listing criteria that could be used by a UDF:

- Contains eligible expenditure as defined by the OP resources to be used by the UDF.
- Revenue generating or facilitates revenues to be captured from an external party to repay a UDF investment
- Requires investment within the timescales of the OP
- Does not involve the UDF providing State Aid to the Urban Project or provides State Aid in a manner that is likely to be acceptable.

1.3.3 Expected Income Receipts and Capital Receipts

The UDF should produce financial projections for the fund as part of its Business Plan. This may build upon the JESSICA Evaluation Study and UDF Investment Strategy as well as information obtained on identified potential final recipients (see *section 1.3.2*). These financial projections should be more detailed than those set out in the JESSICA Evaluation Study and the HF/MA Investment Strategy as they should now be based on more accurate data available on the targeted portfolio of Urban Projects.

The fund projections will typically cover the life of the UDF or will cover a period at least to the exit from all First Round Investments. The projections should incorporate the following financial indicators:

- Investment profile – the scale and profile of the investments to be made by the UDF. This should reflect an identified portfolio of Urban Projects and should inform the MA

2008, which declares certain categories of aid compatible with the common market in application of Articles 87 and 88 of the Treaty (General Block Exemption Regulation) (OJ L 214, 9.8.2008, p. 3–47) (in the case of SMEs).

or HF of the likely timing of OP resources needed by the UDF to meet the investment profile. It should further illustrate the intention by the UDF to commit the OP resources entrusted to it before end 2015 at the latest or otherwise before the deadline described in the Level II Funding Agreement. The envisaged timing of investments also highlights the need for prudent Treasury Management of Idle Resources already paid to the UDF.

- Operating costs - costs necessary for the running of the UDF. This may include Management Fees, Management Costs, deal arrangement fees, envisaged project development costs, project management costs, contingencies for exceptional project management or project restructuring, publicity/marketing costs, etc.. *See Section 5 of this document for details on Management Costs and Management Fees.*

- Envisaged Income Receipts and Capital Receipts – the envisaged scale and timing of resources returned to the UDF based on anticipated performance/success of the selected Urban Projects.

The Income Receipts and Capital Receipts envisaged by the UDF represent an important evaluation criterion for both the procurement of the UDF, and the appraisal to be carried out by the UDF Fund Manager when finally selecting the Urban Projects. The level and timing of the projected returns on investment will also dictate the size of the envisaged pot of returned resources then available for Follow-on Investments if the funding partners elect to leave their Income Receipts and Capital Receipts in the UDF. Envisaging the future use of returned resources for Follow-on Investments may also be helpful to the MA in order to secure support from stakeholders for the establishment of the UDF and its First Round Investments.

Finally, despite the potential to maximise financial returns on investments, it should be recognised that this is not the primary role of a UDF. Given that the opportunity to deploy EU resources via JESSICA Operations has emerged as a response to perceived market failures in the financing of sustainable urban development, UDF support should seek to demonstrate the non-financial impact expected of it. For First Round Investments, this is measured by the UDFs ability to deliver outputs associated to the OP resources made available to the UDF.

1.3.4 Exit Strategy

As defined within COCOF Note 3 an Exit Strategy is : *"...a policy/strategy for the liquidation of holdings by a venture capital or private equity fund according to a plan to achieve maximum return..."*

For JESSICA Operations, there are two scenarios: an Exit Strategy may define the process by which (1) a UDF removes investments from an Urban Project, or (2) a HF/MA removes its resources from a UDF. Exit strategies for both of these scenarios are outlined below and should be articulated within the UDF Investment Strategy:

- ***Exit by the UDF investment from an Urban Project*** - the anticipated timing of the withdrawal of resources invested in an Urban Project, and the potential nature of the exit. The nature of exit will depend on the type of intervention (such as Equity, loan, and Guarantee), the type of Urban Project, and its anticipated performance (financial, and generation of benefits/outputs). The Exit Strategy will typically be agreed between the Urban Project Manager and the MA / HF (as part of entering into a Level II Agreement) prior to investment in an Urban Project.

It is an express requirement of Article 43(3) (c) of the Implementing Regulation that an "*exit policy for the contribution from the Operational Programme out of the Financial Engineering Instruments*" into an Urban Project be incorporated into the Level II Funding Agreement. ***Exit by the MA (or HF) or other investor from the UDF*** – in the event that the UDF is wound up, or its investors seek an exit route (for instance after the first round of Urban Projects), the order and timing of Income Receipts and Capital Receipts from the UDF to the funding partners must be clear to all parties. Articles 44(3) (c) and (d) of the Implementing Regulation refers to exit strategies and Winding Up provisions required for this level of exit.

The proposed Exit Strategy is therefore an important feature of the UDF Investment Strategy, and has financial implications for a number of stakeholders throughout the JESSICA fund lifecycle, including:

- HF/MA – the strategy for the UDF to exit from investments in Urban Projects could be based on hurdles or triggers agreed between the UDF and HF/MA as part of a finalised Investment Plan and Level II Funding Agreement;

- Other Investment Partners – other investors (public or private sector) providing either National Co-financing contributions for the ERDF resources or general Co-Investment resources. These partners may have requirements around the profile of Income Receipts and Capital Receipts (for instance the order, timing and level of return on investment);

- UDF operator – the Exit Strategy can affect the life of the fund, the level of resources under management, and the potential to generate a profit share based on performance of the investments in Urban Projects; and

- Urban Project managers – as the recipients of investments from a UDF at Urban Project level, the managers must agree terms of investment with the UDF Fund Manager, and subsequently deliver the Urban Project in accordance with performance expectations to trigger the Exit Strategy for resources received from the UDF.

1.3.5 Follow-on Investment Principles

Subject to the terms of the agreed Exit Strategy for the UDF, there may be an opportunity to reinvest the Income Receipts and Capital Receipts generated by First Round Investments. Follow-on Investment is covered in detail in section 3.4.

As part of the UDF Investment Strategy, the UDF should outline principles that will guide any Follow-on Investment. For example:

- Is there an intention to reinvest returned resources into new opportunities?

- Has the UDF already identified a pipeline of Urban Projects for consideration after the investment cycle for First Round Investments? For instance, a portfolio of attractive and deliverable Urban Projects aligned to OP objectives but not meeting the timescales for First Round Investment may have been established as part of project scoping exercises carried out.

- Will the UDF take a more 'commercial' approach for Follow-on Investments, where financial returns are given greater priority than for First Round Investments? This may imply investing in Urban Projects that are not necessarily aligned to the OP objectives conditioning the First Round Investments (e.g. housing, retail developments)?

1.3.6 Approach to Monitoring and Evaluation

Section 4, Monitoring, Audit and Reporting, sets out the role for the UDF operator in monitoring investment performance, managing Urban Projects and coordinating Urban Project and programme reporting between the Urban Projects, UDF operator and the HF/MA.

Within the Investment Strategy, the UDF will need to describe its proposed Urban Project monitoring activities, and identify the key stakeholders and their roles throughout the process. Monitoring obligations will need to be covered within the Level II Funding Agreement between the HF/MA and the UDF as specified within Article 43(3) (b) of the Implementing Regulation: *"The funding agreement shall include at least the following elements... (b) provisions for monitoring of implementation". Monitoring and Reporting is considered in detail in Section 4.*

Where there is an HF, the Level I Funding Agreement between the MA and the HF is required to include:

- setting up and monitoring of the investment policy; and
- monitoring of investments in accordance with the required rules (Article 44(2) (d) and (f) of the Implementing Regulation), noted below:

"The funding agreement ... shall, in particular make provisions for: (d) the setting up and monitoring of the investment policy or the targeted urban development plans and actions; (f) monitoring of the implementation of investments".

If the HF has an existing monitoring and Evaluation obligation within the Level I Funding Agreement (and the terms of this obligation could have implications on operation of the UDF), the UDF Operator must be informed.

Compliance with the ERDF monitoring requirements will therefore either be applied directly by the MA or HF by way of its agreement with the UDF.

1.3.7 Other Key Issues

In addition to the key areas set out above, the UDF operator will need to ensure that the Investment Strategy addresses any other issues that are specific to the JESSICA fund in question. These other issues will emerge from reviewing the HF/MA Investment Strategy, or in the call for expressions of interest through the procurement process for the UDFs, and discussions with the HF/MA, as well as the detailed work carried out by the UDF Fund Manager in the course of developing the UDF Investment Strategy. The issue will be specific to the JESSICA structure in question, but could include:

- Compliance with eligibility – ensuring that the UDF invests in a manner consistent with any national rules or requirements of National Co-financing partners, including investment in 'Major Projects' (*see below*)

- State Aid – identifying any potential issues to be discussed and agreed with the HF / MA (*considered in Section 1.5*)

- Other risks – identify the key risks within the UDF Investment Strategy, their potential impact and likelihood, and any mitigating actions that can be taken.

The HF/MA will need to ensure that the UDF Investment Strategy addresses the need for consistency with (1) the applicable OP and IPSUD, (2) the requirements of Article 43 (3), Article 45 and Article 46 of the Implementing Regulation[8] (3) State Aid rules (e.g. on a no aid basis in line with the market economy investor principle), (4) the eligibility requirements of Article 7 of the General Regulation of 5th July 2006 on the European Regional Development Fund (as amended "General Regulation") [9], and (5) Article 11 of Regulation 1081/2006 of 5th July 2006 on the European Social Fund (as amended "Regulation 1081")[10], as is applicable. Compliance with national rules on eligibility (as referred to in Article 56 (4) of the General Regulation) will also need to be addressed.

Major Projects

As defined within Articles 39 – 41 of the General Regulation a Major Project is an "*Operation (funded by ERDF or the Cohesion Fund) comprising a series of works, activities or services intended in itself to accomplish an indivisible task of a precise economic or technical nature, which has clearly identified goals and whose total cost exceeds EUR 25 million in the case of the environment and EUR 50 million in other fields.*"

Under this definition, the contribution of ERDF resources from an HF/MA to a UDF is not considered a 'Major Project.' This is expressly articulated within COCOF Note 3: *"The contribution to Financial Engineering Instruments directly from Operational Programmes or through Holding Funds does not constitute an 'indivisible task(s) of a precise economic or technical nature' within the meaning of Articles 39 of the General Regulation, and hence they cannot be considered Major Projects".* In this context, it should also be taken into account that in respect of assistance implemented through Financial Engineering Instrument, point 1.2.5 of COCOF Note 3 indicates that the operation is constituted by the financial contributions from an OP to Financial Engineering Instrument (including Holding Funds) and the subsequent investments made by the Financial Engineering Instrument.

Therefore, Commission's operation practice to date illustrates that Section 8.5.4 of the COCOF Note 3 (stating that Article 39 of the General Regulation does not apply to Financial Engineering Instrument with the meaning of Article 44) should be understood as also covering the underlying investments carried out by such Financial Engineering Instrument in individual Urban Projects. Therefore, as a consequence, investments made by Financial Engineering Instrument are outside the scope of Article 39 of the General Regulation.

The HF/MA contribution to the UDF will therefore not be required to comply with the "Information Submission to the Commission" requirements set out in Article 40 of the General

[8] Article 43(3) refers to the need for an exit policy and Article 46 refers to public private partnership and other projects including the creation and development of Financial Engineering Instrument such as venture capital, loan and guarantee funds for enterprises
[9] Article 7 sets out limits sets out details of expenditure not eligible under ERDF, including restrictions in terms of eligibility regarding housing, including energy efficiency/renewable measures relating to housing.
[10] Article 11 sets out restrictions in terms of expenditure not eligible for ESF

Regulation and the need for approval under Article 41 of the General Regulation, even if such a contribution (together with the required National Co-financing to facilitate draw down of the Structural Funds) exceeds the threshold (€50 million) set out in Article 39 of the General Regulation (as amended by EC Regulation 539/2010).

1.4 Public and/or private National Co-financing and Co-Investment

The provision of a National Co-financing is a requirement to access ERDF resources from an OP and therefore must be in place in order to draw down ERDF resources into a HF or UDF. OP resources are made up of an ERDF component and a National Co-financing component, with the percentage contribution of each component dependent on the Priority Axis of the OP from which Structural Funds are drawn. These levels vary according to the OP from which the resources are to be drawn for the JESSICA Operation – and more specifically whether the region is covered by Convergence or Regional Competitiveness, and Employment objectives.

Depending on the possibilities foreseen within an OP, National Co-financing can be sourced from public or private sector partners, and contributions usually take the form of cash.

The Co-financed model

In most Member States, National Co-financing is provided from national, regional or local level public resources, and therefore a HF or UDF can be established by way of a reasonably straight forward allocation of these resources to make up the required OP resources. Private sector cash could also be provided as National Co-financing if allowed for in the OP. This type of UDF may be referred to as a 'Co-financed fund', where National Co-financing in the form of public or private monies and ERDF are made available to the UDF when it is established. ERDF draw down can therefore be included in the statement of expenditure to the Commission at the point the UDF is established and National Co-financing is paid into it.

The 'Project Matched' model

An alternative situation is where National Co-financing is provided at Final Recipient level. In this scenario, the UDF must identify investment being made at Final Recipient level and determine which may be categorised as providing National Co-financing. Subject to meeting the conditions for National Co-financing to be eligible when provided at Final Recipient level, the UDF can then draw down from the MA or HF the portion of ERDF to be invested into the Urban Project, alongside the identified National Co-financing. ERDF draw down can therefore be included in the statement of expenditure to the Commission at the point an investment commitment is made by the UDF with a Final Recipient.

Implications for the use of In-kind Contributions

For JESSICA Operations set up after the adoption of the COCOF Note 3, the provision of National Co-financing in the form of In-kind Contribution placed at the level of the Holding Fund or at the level of the UDF could be allowed in cases where there is absolute certainty that the in-kind assets in question will be subsequently invested at Urban Project level[11]. However, in such cases, Eligible Expenditure will not be constituted until the time of effective payment to the Final Recipient.

[11] Section 2.5.14 of the guidance note COCOF Note 3

"Hybrid co-financed" and "project matched" model

It is feasible for a UDF to be established and managed on the basis of part 'Co-financed fund' and part 'Project Matched' fund models in the event that the prevailing local conditions result in a split of National Contribution brought to the JESSICA structure at UDF and/or Urban Project level.

Upon the completion of an initial assessment during the JESSICA Evaluation Study and Investment Strategy stages for the MA, a review of National Co-financing and other contributions needs to be conducted by HFs and UDFs to confirm the eligibility and availability of proposed resources. The aim of the activity is to agree the sources, scale and timing of contributions, determine how this affects the drawdown of ERDF resources into the HF and UDF, and, critically, inform the UDFs investment strategy to ensure it is focused on delivering Urban Projects that meet with OP requirements.

In addition, the HF/MA and UDF must ensure that resource allocations are made in accordance with Structural Fund regulations, as well as any restrictions that apply to other public funding contributions. Therefore, this section considers the Legal Framework and structural requirements associated with the National Co-financing.

Where National Co-financing is supplied in the form of In-kind Contributions (for instance buildings or land assets), the JESSICA Operation must ensure that the assets meet the eligibility requirements, and are committed to the UDF in line with Article 56 (2) of the General Regulation.

Timing of National Co-financing

The Timing of National Co-financing being provided will affect the proposed investment profile of the UDF into Urban Projects. For instance where the National Co-financing is provided in phases (rather than a single contribution at the start of the UDF's operation), the UDF Fund Manager will need to ensure sufficient resources are available to meet the required investment profile across the Urban Projects.

Given that First Round Investments are subject to ERDF compliance requirements (especially the conditions on Eligible Expenditure), commercial banks and institutional investors have proven on occasion to be reluctant to invest in or alongside UDFs as a result of these constraints. The absence of Co-Investment, however, may condition the process of selecting Urban Projects in that First Round Investments may, if deemed appropriate, be directed towards perhaps less financially viable schemes, but schemes that promise higher socio-economic returns.

1.4.1 Legal Framework

The requirements for National Co-financing for Financial Engineering Instruments (such as within the JESSICA mechanism) differs from those generally defined for Structural Funds. National Co-financing is typically applied directly to final beneficiaries for the majority of Structural Funds, but in the case of JESSICA, national public and private contributions can be provided at the HF, UDF and Urban Project level.

The regulations have thus provided more definition around these Co-financing requirements for resources deployed via Financial Engineering Instruments, particularly with respect to accounting for private sector Co-financing.

For instance, in order to meet the requirements of Articles 60(d) of the General Regulation and Article 15 of the Implementing Regulation, it is necessary for UDFs to keep separate accounts or maintain adequate accounting codes in respect of the contributions from Structural Funds from each OP and for each applicable priority axis. Articles 78 and in particular Article 78 (6) of the General Regulation also states that: *"As regards Financial Engineering Instruments as defined in Article 44, the statement of expenditure shall include the total expenditure paid in establishing such funds or Holding Funds."*

The sections that follow, as well as *Section 1.1.3*, further outline the legal requirements for National Co-financing.

1.4.2 National Co-financing provided at Final Recipient level

Where National Co-financing is provided at Final Recipient level, the conditions for its use must be followed as set out within paragraph 2.5.15 of the COCOF Note 3. The guidance note describes that such contributions will only be eligible (and therefore should only be included in a statement of expenditure) if it fully complies with the following conditions:

- there must be documentary evidence of the legal agreement between the private/public co-financing parties and the FEI concerning their contribution to the implementation of the co-financed investment operation;

- the FEI must retain overall responsibility for the investment including subsequent monitoring of the contributions from the OP according to the Funding Agreement;

- the expenditure paid by such private or public entities is supported by receipted invoices or, where this cannot be done, by accounting documents of equivalent probative value;

- the expenditure paid by such private or public entities is reported formally to the FEI which is responsible for verifying the reality and Eligibility of Expenditure claimed before declaring it to the managing authority or certifying authority and;

- the audit trail is maintained down to the level of the payment of private/public co-financing to the final recipient.

Providing National Co-financing at Final Recipient level therefore means that the UDF can only draw down ERDF resources from the MA when all of the above conditions are satisfied.

Therefore, at the time of it being established, the UDF will not receive the ERDF resources that are to be supported by Final Recipient level National Co-financing (as to oppose to ERDF resources it could receive when National Co-financing is provided to the UDF). As a result, the UDF would not benefit any Gains that would arise prior to investing the resources. The provision of National Co-financing by the Final Recipient should result in the ERDF resources from the MA, through the UDF, to the Final Recipient as a back-to-back transaction.

This section sets out the requirements regarding the sources of funding (public and private sector) that can serve as National Co-financing for contributed ERDF resources. The responsibility for ensuring that these requirements are met will be assumed by both the HF/MA and the UDF Fund Manager as the UDF is established.

The contribution of ERDF resources will be subject to applicable ceilings against total eligible expenditure for Structural Funds. These are dependent on the area in question and whether it is covered by convergence or Regional Competitiveness and Employment Objectives. The parameters and limits for contributed ERDF resources shall be set out in the applicable OP approved by the Commission. To drawdown the funding into an HF or UDF, there must be a commensurate contribution of public or private funding (the National Co-financing) ideally sourced by the HF or the UDF.

As a general rule, the private and public contributions into a Financial Engineering Instrument (i.e. a UDF) will be paid simultaneously with the drawdown of ERDF resources when Co-financing is provided at the point a UDF is established (by either a MA or HF). The Commission has also accepted the possibility of contributions being paid into an escrow account as indicated in paragraphs 2.5.9 to 2.5.10 of COCOF Note 3 where they are reserved for use by the UDF in making investments in the final recipients (i.e. at the Urban Project level), subject always to the private or public contribution to a financial engineering instrument paid into an escrow account per se is not eligible expenditure at the closure of the operational programme[12].

In cases where the Co-financing contribution paid from an OP is later withdrawn from a Holding Fund or a financial engineering instrument, and where the Member State has received an interim payment from the Commission for expenditure which has not been spent to implement the underlying operations for which it was declared, this may constitute an irregularity unless the statement of expenditure is subsequently modified to withdraw or replace the expenditure in question. Any such possible withdrawal and replacement must be justified in light of the principle of sound financial management and must not result in an improper circumvention of the provisions of Article 93 of the General Regulation.

1.4.3 In-Kind Contributions

It is possible for the National Co-financing to be provided in the form of non-cash contributions – typically land assets or buildings committed to the fund by a co-funding partner. These contributions can potentially be made at the HF, UDF or Urban Project level as provided for in Article 56(2) of the General Regulation. It should, however, be noted that restrictions on In-kind

[12] On this point, the funds drawn down into a HF/UDF cannot be regarded as eligible expenditure for the Operational Programme (as per Article 78(6) of the General Regulation). Only the following can be considered eligible expenditure:

a) any payments from UDFs for investment in public private partnerships or other projects included in an IPSUD; or
b) any payments for investment in enterprises from each of the above mentioned funds; or
c) any guarantees provided including amounts committed as guarantees by guarantee funds; and
d) eligible management costs or fees (see section 3.1.7); and
e) any loans or guarantees for repayable investments from funds or other incentive schemes providing loans, guarantees for repayable investments, or equivalent instruments, for energy efficiency and use of renewable energy in buildings, including in existing housing.

Contributions set out in Article 56 (2) of the General Regulation apply. The regulation states that for In-kind Contributions to be treated as Eligible Expenditure, the following conditions must be fulfilled:

a) *the eligibility rules drawn up on the basis of paragraph 4 foresee the eligibility of such expenditure;*

b) *the amount of the expenditure is duly justified by supporting documents having equivalent probative value to invoices, without prejudice to provisions set out in specific regulations;*

c) *in the case of contributions in kind, the co-financing from the Funds does not exceed the total of eligible expenditure, excluding the value of such contributions*."

Paragraph 2.5.15 of COCOF Note 3 nevertheless provides a helpful list of features that apply to contributions received at the Final Recipient.

Article 51 of the Implementing Regulation further states:

"1. In-kind Contributions of a public or private beneficiary shall be eligible expenditure if they fulfil the following conditions:

a) *they consist of the provision of land or real estate, equipment or raw materials, research or professional work or unpaid voluntary work;*

b) *their value can be independently assessed and audited.*

2. In the case of the provision of land or real estate, the value shall be certified by an independent qualified value or duly authorised official body."

Where land is provided as an In-kind Contribution, it is advisable to use a valuation methodology consistent with those set out in the Sale of Land Guidelines which states: *"An independent evaluation should be carried out by one or more independent asset valuers prior to the sale negotiations in order to establish the market value on the basis of generally accepted market indicators and valuation standards. The market price thus established is the minimum purchase price that can be agreed without granting State Aid".*

Full details of the basis on which such a valuation should be undertaken is set out in Section 2 of the "Sale of Land Guidelines". It is recommended that instructions to any valuer(s), concerning the valuation of land to be used as an In-kind Contribution, include a copy of the Sale of Land Guidelines.

The availability of In-Kind Contributions could also shape the potential JESSICA Operation and have implications on the UDF Investment Strategy (Section 1.3). In particular:

- In the case of land and buildings being used as In-Kind National Co-financing, the nature of those assets (including any commercial or statutory restrictions) will likely determine the scale and scope of Urban Project activity for investment by the UDF, and subsequently the outputs that can be delivered under the OP; and

Withdrawal of paid contributions

Finally, as underlined by paragraph 5.3 of COCOF Note 3, in cases where the contribution paid from an OP is later withdrawn from a HF or UDF, and where the Member State has received an interim payment from the Commission for expenditure which has not been spent to implement the underlying Operations for which it was declared, this may constitute an irregularity unless the statement of expenditure is subsequently modified to withdraw or replace the expenditure in question.

Any such possible withdrawal and replacement should comply with the principle of sound financial management and should not result in an improper circumvention of the provisions of Article 93 of the General Regulation[6].

1.5 State Aid

A large number of relevant EU regulations and references to national rules are integrated across this document. However, given the complex nature of State Aid provisions relating to UDFs, an overview is provided here that should be considered by the reader throughout the handbook.

Establishing JESSICA Operations can be rather complex and the possibility of State Aid being deemed to be present in any given structure is relevant throughout the process. UDF Fund Managers have, under the overall responsibility of national MAs, an on-going requirement to ensure any Structural Funds (and other State resources) are deployed in strict compliance with State Aid rules (within Articles 107-109 of the TFEU). The presence (and if so compatibility) of State Aid must be assessed at the various levels of the JESSICA Operation, including at investor level, fund manager level and Urban Project level.

There are also different considerations to be taken into account, depending on the nature of the investment instruments (i.e. loan, equity or guarantee) utilised in a JESSICA Operation, when seeking to ensure compliance with the State Aid rules. Section 2.2.2 of the Holding Fund Handbook (State Aid considerations) provides further background to this topic area.

Key State Aid documentation

The following EU-level guidance, notice documents and regulations[13] are all potentially relevant (depending on the nature of the Urban Projects to be invested in and the structure and form of the investments to be made) for the initial investment strategy of the HF/MA and UDF, details of which are elaborated on within this section:

- EU Regulation No 1998/2006 of 15 December 2006 on the application of Articles 87 and 88 of the Treaty to De Minimis aid OJ L 379, 28.12.2006, p. 5–10 aid

- EU Regulation No 800/2008 of 6 August 2008 declaring certain categories of aid compatible with the common market in application of Articles 87 and 88 of the Treaty (General Block Exemption Regulation) OJ L 214, 9.8.2008, p. 3–47 ("the General Block Exemption Regulation" or "GBER")

[13] For a compilation of State Aid rules in force, including the ones mentioned in this handbook please compare: http://ec.europa.eu/competition/state_aid/legislation/compilation/state_aid_03_03_12_en.pdf

- Community Guidelines on State Aid to promote risk capital investments in small and medium-sized enterprises OJ C 194, 18.8.2006, p. 2–21 (“the Risk Capital Guidelines” or “SARC”)

- Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State Aid in the form of Guarantees OJ C 155, 20.6.2008, p. 10–22 (“the Guarantee Notice”)

- Communication from the Commission on the revision of the method for setting the reference and discount rates OJ C 14, 19.1.2008, p. 6–9 (“the Reference Rate Communication”)

- For environmental measures (e.g. energy efficiency Urban Projects), the Community guidelines on State Aid for environmental protection OJ C 82, 1.4.2008, p. 1–33 (“the Environmental aid Guidelines”)

Other EU-level guidance, notice documents and regulations (e.g. those relating to R&D&I[14] or regional investment[15] could also potentially be relevant depending on the nature of a UDF’s operations and the circumstances surrounding any given Urban Project that the UDF may invest in. It is important therefore that a UDF consults with an appropriately qualified lawyer in order to ensure that the particular features of its operation are reviewed and potential State Aid issues have been adequately addressed. This section of the Handbook is therefore designed to summarise some of the issues facing UDF operations and does not provide specific guidance or advice on achieving State Aid compliance.

The basis on which State Aid compliance is to be achieved will need to be considered when assessing the Business Plan and investment strategy of each UDF. The above guidelines, notices and regulations include details on how certain types of investments (involving State resources - which are deemed to include Structural Funds) can be deployed, either without the provision of State Aid as defined in Article 107 TFEU or as compatible State Aid (i.e. State Aid that is compatible with the internal market by way of it being consistent with the block exemption regulation, an existing Commission approved State Aid scheme or by it being individually notified to and approved by the Commission). In certain cases where State Aid is present in a JESSICA Operation, a formal notification to the Commission by the relevant Member State, via the MA or other relevant responsible body, may be necessary (particularly if the form of any aid includes equity or quasi equity investments).

If Commission approval of the structure is required, then the MA (or other relevant responsible body) is required to notify to the Commission full details of the fund structure that provides for the grant of aid (i.e. in terms of investments made by the UDFs) and can request that the Commission approves State Aid contained in the structure as being compatible with the TFEU. This process will involve a review of the notified structure with the Commission and upon conclusion of an initial review, the Commission will communicate to the MA (or other relevant responsible body) by way of a formal State Aid decision whether it considers the State Aid in question to be compatible with the TFEU, the State Aid to be incompatible with the TFEU (and thus bars it being granted) or that it intends to undertake a wider and more in-depth investigation of the measures in question (seeking views from all interested parties) to

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[14] Community Framework for State Aid for Research and Development and Innovation *OJ C 323, 30.12.2006, p. 1–26*

[15] Guidelines on national regional aid for 2007-2013 (Text with EEA relevance) *OJ C 54, 4.3.2006, p. 13–44*

determine if it can be regarded as compatible aid (such investigations are generally only undertaken where the Commission has initial doubt as to the compatibility of any State Aid measures notified to it). Any decision by the Commission, regarding the compatibility or otherwise of any State Aid notified to it, will be through a formal State Aid decision and this will set out in detail the basis on which the structure will be required to operate, in order for any State Aid measures within it to be deemed as approved by the Commission. UDFs and UDF Fund Managers must ensure that investments comply with the terms of any State Aid decision (details of which are published by the Commission on the State Aid pages of the EUROPA website[16]) issued by the Commission regarding a particular JESSICA Operation.

Aid within JESSICA Operations

Under the terms of Article 107 of the TFEU, in order for a measure to amount to State Aid it must include all of the following elements:

- Involve the use of State resources;
- Provision of a selective benefit to an "undertaking";
- Result in the distortion or the threat of distortion of competition; and
- Produce an effect on trade between Member States.

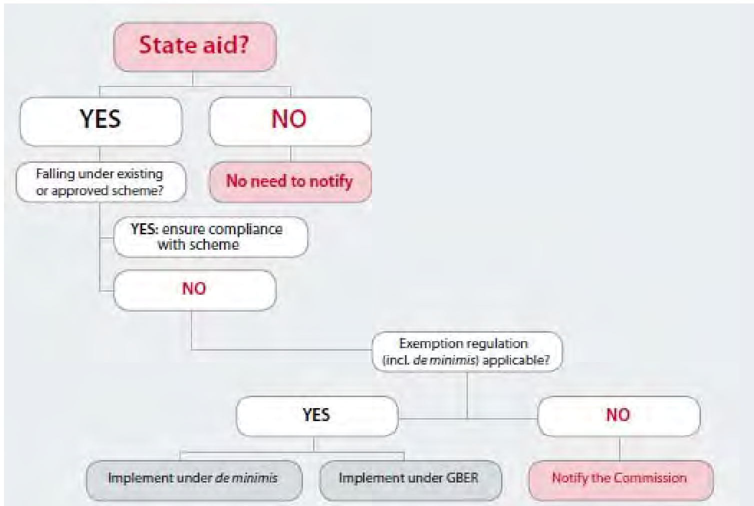
Only if all of these elements are present in a measure can it amount to State Aid and be subject to the general prohibition on State Aid, without the prior approval of the Commission, as set out in Article 107 (1) of the TFEU.

At the UDF level and below, there are a number of areas where State Aid could be deemed by the Commission to arise in a JESSICA Operation:

- The UDF itself, in terms of a recipient of resources provided to it by the HF could be deemed to give rise to State Aid. Such vehicles (as is the case at the HF level) are, however, generally regarded by the Commission as operating simply as conduits for transferring resources to Urban Projects rather than being beneficiaries of any State Aid themselves;
- UDF Fund Managers - through the receipt of remuneration for investment management services provided, which possibly amounts to an overcompensation (i.e. it cannot be demonstrated that it is in line with market rates of remuneration for such services);
- Private investors in UDFs - through preferential treatment in terms of their investments as compared to public investment (i.e. should it be deemed that investments do not operate on a strict Pari Passu basis); or
- Urban Project promoters (and other investors) - through provisions to them by the UDF of funding measures in the form of sub-commercially priced equity, loans or guarantees.

[16] http://ec.europa.eu/competition/elojade/isef/index.cfm?clear=1&policy_area_id=3

The following decision tree diagram, taken from the Holding Fund handbook, outlines the recommended process of determining a strategy for a UDF in addressing the provision of aid (based on the definition of State Aid set out in Article 107(1) of the TFEU) within its operations.



The diagram illustrates three options with regards to approaching the provision of State Aid that should be considered within the investment strategy that the UDF adopts for its operations:

- Delivering UDF operations free from State Aid;
- Providing State Aid which is compatible under existing State Aid rules (such as under the De Minimis Regulations, General Block Exemption Regulations or on the basis of compliance in full with the terms of an existing Commission approved State Aid scheme).; and
- Seeking formal approval from the Commission for the provision of aid based on an agreed structure and investment criteria. Due to the complexities of individual JESSICA Operations this is likely to be the safest option for ensuring State Aid compliance is achieved.

The remainder of this section reviews these three options and the implications for a UDF.

1.5.1 Implications for UDF operations free from State Aid

If the UDF aims to operate entirely without giving rise to State Aid, investments into the UDF and any Urban Projects must be structured on *"terms which would be acceptable to a normal economic operator in a market economy,"* (i.e. its invests resources in line with "Market Economy Investor/Lender Principle" or "MEIP"). This could involve:

- Loans on a fully commercial basis (including but not limited to the rate of interest applied to any such loan);
- Equity or quasi equity investments on terms that are Pari Passu to those being offered by private sector co-investors; and

- Guarantees which meet in full the 'no aid' requirements of Section 3 of the Guarantee Notice[17].

- Funding in line with the amounts and provisions of the De Minimis Regulation.

Determining if State Aid is present in a Urban Project investment being made by a UDF or at the level of investments in the UDF itself will be depending on the nature of the investment - specific guidelines exist regarding loans[18], guarantees[19] and both equity as well as quasi equity investments[20], which set out the basis on which the application of such measures will and will not be presumed to involve the grant of State Aid. *These are also referred to in the existing Holding Fund Handbook and also the UDF Typologies study.*

Loans

Where a loan is made on a purely commercial basis (i.e. on terms that a prudent private sector lender would lend on, with a view to making a reasonable profit) then no State Aid will be deemed to be granted as no benefit accrues to the recipient entity (over and above that available on the market). Ascertaining if this is the case includes the following assessments:

- The UDF Fund Manager will be satisfied that the Urban Project to which the Loan is to be given is commercial in nature and will make a return from which the loan is capable of being repaid in full (including applicable interest). In some cases, UDF Fund Managers may choose to obtain an independent assessment of the Urban Project Business Plan to be satisfied on this point;

- The UDF Fund Manager must act in a manner consistent with that of a prudent private sector lender, motivated by profit rather than any socio economic factors;

- The loan itself must be on fully commercial terms. This will include the interest rates and collateral provided, together with other requirements that a prudent private sector lender would ordinarily include in a loan agreement. This includes the need for the interest rate applicable to any loan being at least in line with the "Reference Rate Communication". The applicable rate in line with the "Reference Rate Communication" will, in each case, depend upon the base rate set by the Commission for the applicable Member State where and at the time that the UDF investment takes place, together with the required margin which is dependent upon the credit rating of the recipient entity and the level of collateral to be provided;

- The UDF Fund Manager is advised to obtain an independent financial assessment in order to determine the minimum required interest rate (with respect to State Aid

[17] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State Aid in the form of guarantees *(OJ C 155 of 20.06.2008, page 10)*

[18] Communication from the Commission on the revision of the method for setting the reference and discount rates *(OJ C 14, 19.1.2008, p. 6–9)*

[19] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State Aid in the form of guarantees *(OJ C 155 of 20.06.2008, page 10)*

[20] Community guidelines on state aid to promote risk capital investments in small and medium-sized enterprises (Text with EEA relevance) *OJ C 194, 18.8.2006, p. 2–21* and Section 6 of the General block exemption Regulation

compliance) and the nature of terms to be applied to the loan in order to make it fully commercial; and

- Any loan must not be made to an entity that amounts to a "firm in difficulty", details of which are set out in section of 2.1 of the of the Community Guidelines on State Aid for rescue and restructuring of firms in difficulty[21] ("the Rescue and Restructuring Guidelines") and section 1(7) of the General Block Exemption Regulation.

Guarantees

The Guarantee Notice indicates that a Guarantee provided through State resources will not be deemed to involve any elements of State Aid if the following criteria are met in full:

- ***The borrower is not a firm in difficulty*** – as set out in the Rescuing and Restructuring Guidelines or, in the case of SMEs, Section 1.7 of the General Block Exemption Regulations (which provides that SMEs that have been incorporated for less than three years shall not be considered as being in difficulty during that period even if they meet all other requirements for being a firm in difficulty);

- ***The extent of the Guarantee can be properly measured when it is granted*** - the guarantee must be linked to a specific financial transaction (in a UDF's case usually a loan obtained by a qualifying Urban Project) and must be for a fixed maximum amount and be limited in time;

- ***The guarantee does not cover more than 80% of the outstanding loan or other financial obligation*** – this is in order to ensure that the lender effectively bears part of the risk and for this purpose due attention must be given to the following two aspects:

    - when the size of the loan or the size of the financial obligation decreases over time, for instance when the loan is reimbursed, the guaranteed amount has to decrease proportionally in such a way that at each moment in time the guarantee does not cover more than 80% of the outstanding loan or financial obligation; and

    - Losses have to be sustained proportionally and in the same way by the lender and the guarantor. In the same manner, net recoveries (i.e. revenues excluding costs for claim handling) generated from the recuperation of the debt from the securities given by the borrower have to reduce proportionally the losses borne by the lender and the guarantor. First-loss guarantees, where losses are first attributed to the guarantor and only then to the lender, may be regarded as giving rise to aid.

- A market-oriented price is paid for the guarantee by way of an appropriate premium on the guaranteed or counter-guaranteed amount. When the price paid for the guarantee is at least as high as the corresponding guarantee premium benchmark that can be found on the financial markets, the guarantee will not constitute aid. If no corresponding guarantee premium benchmark can be found on the financial markets,

[21] *OJ C 244, 1.10.2004, p. 2–17*

the total financial cost of the guaranteed loan, including the interest rate of the loan and the guarantee premium will be compared to the market price of a similar non-guaranteed loan.

In order to determine the corresponding market price, the characteristics of the guarantee and of the underlying loan should be taken into consideration. This includes:

- The amount and duration of the transaction;
- The security given by the borrower and other experience affecting the recovery rate evaluation;
- The likelihood of default of the borrower due to its financial position, its sector of activity and prospects; and
- Other wider economic conditions.

This analysis should allow the borrower to be classified by means of a risk rating. This classification may be provided by an internationally recognised rating agency or, where available, by the internal rating used by the bank providing the underlying loan. The Commission also points to the link between rating and default rate made by international Financial Institutions, whose work is also publicly available[22].

To assess whether the premium is in line with the market prices the UDF can carry out a comparison of prices paid by similarly rated undertakings on the market.

For guarantees provided to SMEs, the premium charges will be deemed to be at a market oriented rate if it is at least equal to the rate which would apply if calculated in accordance with the valuation mechanism set out in section 3.3. of the Guarantee Notice.

Equity/quasi equity

Equity or quasi equity investments made by a UDF can also constitute State Aid if such investments do not reflect current market conditions (i.e. are not in compliance with MEIP). Typically, the UDF's equity status will include a profit share element from the Urban Project and status in a winding up or liquidation scenario. In any of these instances, if the UDF adopts a position which gives another investor a level of return that could not otherwise be obtained under normal commercial conditions, then the UDF could be providing aid to the Urban Project or that investor.

Equity or quasi-equity investments made by the UDF on a strict Pari Passu basis with other investors may not constitute State Aid. The Commission has stated within the Risk Capital Guidelines that it: "*will consider the investment to be effected Pari Passu between public and private investors, and thus not to constitute State Aid, where its terms would be acceptable to a normal economic operator in a market economy in the absence of any State intervention. This is assumed to be the case only if public and private investors share exactly the same upside and downside risks and rewards and hold the same level of subordination, and normally where at*

[22] See footnotes 9 and 11 of the Commission Notice on the application of Article 87 and 88 of the EC Treaty to State Aid in the form of Guarantees.

least 50 per cent of the funding of the measure is provided by private investors, which are independent from the companies in which they invest."

In summary, this guidance states that the equity / quasi equity investment of a UDF must:

- Share exactly the same upside and downside risks and rewards as other private investors;
- Hold the same level of subordination as other private investors;
- Be part of an overall funding package where at least 50% of the funding is provided by private investors; and
- Ensure that the private investors in question are independent from the entity invested in.

Common practice by UDFs making equity investments into Urban Projects without providing State Aid is to take identical terms to the commercial investors. Where this is not the case, State Aid may arise in any such JESSICA Operation intended to be implemented on such a basis (unless the relevant equity or quasi equity investments were to be solely applied to SMEs, which is considered unlikely in a JESSICA Operation). In this instance, the investment should be formally notified to the Commission for assessment and cannot be implemented until Commission approval is obtained. An example of this can be found in the Commission approvals of the UK "North West Urban Investment Fund (JESSICA)" Scheme[23] and the Andalucía JESSICA Holding Fund[24].

UDF providing Equity investments into Urban Projects

The Ahorro Corporation is appointed to run a UDF in Andalucía, Spain which provides Equity, Quasi-Equity (participative loans) and long term loans. The Andalucía region has a range of urban priorities that the UDF is targeting nearly €90 million of investment at;

- Brownfield land redevelopment
- Urban infrastructure
- Renewable energy and low carbon
- Improvements in energy management, energy efficiency and waste management
- Development of technology clusters through harmonizing city infrastructure to create facilities for SMEs and innovative firms

The UDF is using two investment vehicles to separate the loans and equity products. An evaluation study for the region[25] identified a short fall in the amount of equity finance available from the private sector to support the above types of investment. Amongst the reasons for the lack of private equity being made available were:

[23] SA.32835 (2011/N) United Kingdom Northwest Urban Investment Fund (JESSICA).
[24] SA.32147 – Andalucía JESSICA Holding Funds
[25] http://www.eib.org/products/technical_assistance/jessica/studies/index.htm#es

- Little incentive for private markets to deliver non-financial outputs, such as environmental benefits, improved neighbourhoods and health impacts

- Reluctance of investors to provide equity due to a lack of information to properly assess all the risks of an investment in these projects

- Typically lengthy pre-construction periods requiring patient investors who can accept long periods before returns arise

- General capital and liquidity constraints imposed on financial institutions by the impact of financial crisis reducing the amount of finance made available for urban project investment

The Managing Authority, in conjunction with the Commission and the EIB, supported the preparation of a State-aid notification that would allow the UDF to provide equity in a sub-commercial form that would allow private investors to provide equity on non parri-passu terms to the public sector – therefore encouraging more private equity to flow into projects supported by equity from the UDF on preferential terms. The proposals allowed the UDF to:

- Secure a return rate lower than a private investor;

- Let private investors take their return first (to a level deemed to be a fair rate of return – see later in this Chapter 1.5.3 for innovative approaches);

- Take first losses with an Urban Project to protect some of the private investment.

A copy of the full State Aid notification can be found at:
http://ec.europa.eu/competition/state_aid/cases/240808/240808_1295596_79_2.pdf

The notification provides detail on the obligations of the fund manager of the UDF and the conditions that must be present in all projects it invests in, not least:

- Private investors must cover at 30% of all Eligible Expenditure of the Urban Project;

- An Urban Project must be able to demonstrate it has taken reasonable efforts to secure finance prior to contacting the UDF (the 'Necessity Test'), which includes demonstrating the project is not viable to receive funds from the private in the current market conditions;

- The fair rate of return for the private investors has been independently established through either a competitive process or the work of an independent assessor.

1.5.2 Implications for UDF Operations containing State support compatible with current State Aid provisions

Following analysis of UDF investment operations to determine if State Aid is present, it may be possible for the UDF to still provide support such as asymmetric investment conditions to Urban Projects under existing State Aid provisions without having to seek a formal approval from the Commission (with any approval based on the measures falling within an existing block exemption and thus being automatically approved as compatible aid or, in the case of De Minimis aid, on basis it is not State Aid).

The De Minimis Regulation

A UDF Fund Manager may apply funding to a specific Urban Project without the need for formal approval from the Commission, if all such funding is provided in full compliance with the requirements of the De Minimis Aid Regulation (subject always to there being no other elements of State Aid elsewhere within the JESSICA Operation i.e. at a higher level). To utilise the safe harbour provided by the De Minimis Aid Block Exemption, the funding provided to any single beneficiary must:

- Be less than €200,000 over any rolling three fiscal year period (taking into account accumulation provisions that require that any other De Minimis aid received by the recipient during that period and any other State Aid applied by the recipient to the same costs as any proposed De Minimis aid is included in calculating whether the €200,000 cap is complied with). Recipient entities are required to complete a declaration confirming this is the case; and

- Be full and transparent in nature so that the total amount of "De Minimis aid" to be granted can be calculated in advice of any De Minimis aid being given. This means that equity or quasi equity investment cannot be justified on the basis of De Minimis aid, unless the total amount of the investment is less than €200,000 (subject always to the accumulation provisions detailed above). In addition, any guarantee containing elements of aid can only be justified as De Minimis aid if the instrument guaranteed (which in this case must be a loan) is no greater than €1.5 million. Again, this is subject to the accumulation provisions detailed above. Full details are set out within the De Minimis Aid Regulation itself.

In the context of UDF investment operations, examples of a gross grant equivalent, where a UDF is providing investments at below market rate, are as follows:

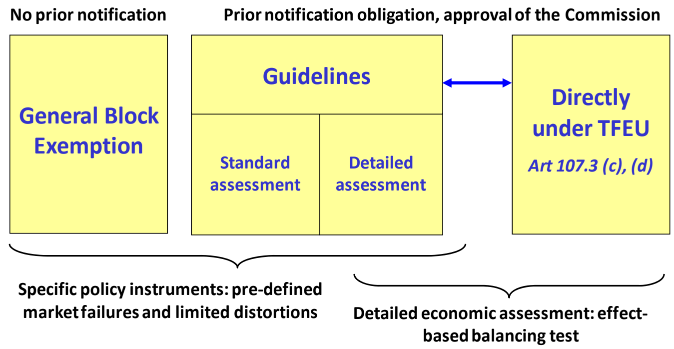
- The present value of the difference between the market interest rate for a loan and the interest rate charged by the UDF over the full terms of the loan. The reference rate communication is typically used to establish the market interest rate; and

- The present value of the difference between the market rate for guarantee fees and the fee charged by the UDF over the full term of the guarantee.

As indicated above, equity or quasi equity investments are not considered to be transparent aid under the State Aid provisions and therefore the total amount of equity/quasi equity investment should be treated as grant and must fall within the €200,000 De Minimis cap (taking into account other De Minimis aid received or other aid measures applied, or to be the same costs as, any proposed De Minimis aid by the recipient during the relevant rolling 3 year period).

General Block Exemption Regulations ("GBER")

The basis on which State Aid can be provided under the existing Commission State Aid Rules is illustrated in the diagram below:



The GBER provides a framework for Member States to provide certain forms of State Aid to address distinct market failures and sets out the basis on which this must be applied to avoid potentially unacceptable distortions of competition or trade.

The GBER defines conditions under which State Aid, while present, is not required to be pre-approved by the Commission and includes a number of distinct measures (including those covering regional aid, investment aid, environmental aid and aid in the form of risk capital measures). The GBER provides detailed guidelines as to the basis on which provided State Aid will be deemed to be approved, including:

- Locations within which assisted Urban Projects must be located. This is generally applicable to certain investment and employment aid measures, but also potentially relevant in terms of the level of permitted funding as a percentage of Eligible Expenditure under other State Aid measures within the GBER;

- Details of Eligible Expenditure against which funding must be applied (these will depend on the nature of the supported Urban Project and the relevant measure under the GBER being utilised to justify the proposed State Aid);

- The maximum percentage of Eligible Expenditure that can be supported by the State Aid measure ("maximum aid intensities");

- The maximum level of funding against Eligible Expenditure, before which a formal notification is required should these levels be exceeded ("notification thresholds"); and

- Levels of other (private sector) investment that must take place alongside the public funding that had resulted in the presence of State Aid.

Due to the limited basis on which non Market Economy Investor Principle (MEIP) compliant equity and quasi equity investment measures can be justified under the GBER (limited to investment in SMEs) and the limited value of the De Minimis aid block exemption for larger investment amounts, structures that operate by providing some form of equity or quasi equity investment may need to be formally notified to and assessed for compatibility by the Commission before they come into effect.

Any provision of State Aid that not fully in compliance with the requirements of the GBER or the De Minimis aid block exemption (as outlined above) or an existing Commission approved scheme (which as detailed above may be rare due to the diverse nature of potential JESSICA Schemes), can only be made after the Commission has approved the relevant State Aid measures (following a formal notification setting out all aspects of the basis on which the scheme is intended to operate). The UDF Fund Manager needs to consider, in light of State Aid provisions, the proposed UDF operations and determine if any approvals are required before the UDF commences operations. Innovative applications have been made by MAs on behalf of their JESSICA Operations to provide aid for their operations – illustrations of these are provided next in section 1.5.3.

1.5.3 Innovative Approaches to State Aid notifications

If the proposed scope of activities defined within a prevailing Integrated Plan for Sustainable Urban Development is expected to result in aid being provided through UDF operations and this aid is not permitted under an existing Commission approved State Aid scheme or block exemption measure (outlined above), a notification must be made for formal Commission approval of such State Aid. Until such approval is obtained this measure must not be implemented.

Responsibility for initiating the formal approach to the Commission will differ from Member State to Member State in respect of approval of any State Aid measures (that do not fall within the terms of any existing block exemption or approved scheme), but any responsible authority would expect to work closely with the MA, the HF and/or the UDFs or if the MA is the responsible body it will need to work closely with the HF or UDFs whose proposed operations trigger the need for a notification to, and approval from, the Commission of any State Aid measures. As part of the preparation for the notification application, the MA or other relevant body must ensure that it can demonstrate:

- A targeting of an EU objective of common interest, which is not sufficiently attractive to the commercial market due to efficiency matters (such as high costs, uncertain revenues or imperfect information) or equity matters (including the uncertainty of profitability due to location characteristics or urban planning constraints), i.e. the presence of a clear market failure must be demonstrated;

- A well designed, procured and operated structure that conforms to expectations of good practice for the setting up and operation of Financial Engineering Instrument;

- The proposed aid will have a minimal impact on trade and competition when balanced against the benefits it provides (i.e. in addressing a clear market failure).

The application must demonstrate that it is addressing a market failure that is resulting in economic underperformance and by doing so, is strengthening socio-economic cohesion in its targeted urban areas (in line with an IPSUD).

Other key areas that the Commission will consider in terms of assessing the compatibility of any State Aid measures notified to it are as follows:

Appropriateness of the State Aid measure

The Commission will expect evidence to be provided which demonstrates that the identified market failures will be properly addressed by the design of the JESSICA Operation. This will require submission of evidence of the relevant market failure and why the measures proposed (rather than other possible intervention routes) are the most appropriate / least distortive in terms of addressing any such market failures. This will require a commitment from a UDF Fund

Manager verifying a number of financial requirements prior to making an investment, including professional Urban Project appraisal based on financial forecasts so as to ensure that Urban Projects to be invested in are feasible from an economic, technical and social point of view. Such appraisal should operate to ensure that only Urban Projects affected by identified market failure are eligible for State Aid measures under the proposed structure.

Requirements in terms of the implementation of a JESSICA financial instrument which assists in determining the appropriateness of State Aid measures within any such structure include:

- Public resources being applied as repayable investments to the UDF and then invested in the form of equity or loans to Urban Projects (as is required by the structural funds rules relating to Financial Engineering Instrument);

- Grant funding – if foreseen - combined with any repayable investment being subject to the same conditions and limitations (so as to avoid a doubling up of aid to Urban Projects);

- UDFs with a significant level of private co-funding applied to each Urban Project; and

- UDFs managed by professional and independent fund managers.

Notifications should be drafted on a basis whereby these points are flagged.

Incentive effect

The effect of any aid measure must be to encourage activity (in relation to a legitimate objective), which would not take place at all or to the same extent in the absence of the availability of the proposed State Aid. In the absence of any incentive effect, the provision of aid would provide support for something that would be undertaken in any event and thus represent a windfall for the recipient entities. Such a windfall would be viewed by the Commission as highly distorting of competition and trade.

Evidence must therefore be presented to the Commission within any notification that the proposed State Aid measures will change the behaviour of private sector investors so that they are encouraged to undertake or invest in urban regeneration Urban Projects.

Such evidence should include the following:

- Investment in Urban Projects should only be made prior to such Urban Projects commencing;

- Investments should not be made in Urban Projects which would result in support to enterprises than cannot repay even the capital invested (i.e. not in cases where there is a less than zero rate projected return, net of management fees). This ensures that support is not provided to inefficient enterprises and supports the sustainability of the UDF. This should form part of the Business Plan appraisal process which in turn should operate to ensure investments are made on the basis of a realistic Business Plan (assessed by an entity that has a duty of care in reviewing such plans and which ideally remunerated on the basis – at least in part of the overall investment value so as to encourage investments to be made in efficient Urban Projects only);

- Investments which involve some element of State Aid should only be provided to Urban Projects that can demonstrate that without aid an acceptable rate of return for the private sector is not possible and, as a result, such Urban Projects would not be undertaken at all or to the same extent without an element of State intervention. This requires any Urban Project assessment to establish the presence of a viability gap.

Proportionality

In all cases, the level of State Aid proposed to be granted must be shown to be limited to the minimum amount necessary to address the relevant market failure. Compatibility of any State Aid measure will only be deemed by the Commission to be achieved where the same result cannot be achieved by lower levels of State Aid.

Evidence will be required by the Commission as to the criteria and process that will be put in place to ensure any advantage provided to private sector investors is the minimum amount necessary. This is particularly the case in terms of structures that include equity and quasi equity forms of investment where it is not possible to demonstrate in advance the gross grant equivalent of the relevant State Aid measure.

Areas that the Commission will expect to be addressed in respect of evidencing proportionality include:

- Maximum level of investments to be made by UDFs in any one Urban Project;

- Minimum levels of private sector participation; and

- Limitations on the levels of profitability for private sector investors (e.g. return as linked to the market orientated maximum fair rate of return).

Sound investment management

In order to be able to demonstrate to the Commission in any notification that any State Aid provided will be limited to the minimum amount necessary, it is necessary to provide evidence that the investment decision making process followed by the UDF is operating in a manner that aligns with commercial logic and follows best commercial practice. Such evidence should ideally include the following:

- Selection of the UDF Fund Managers on basis of procurement in accordance with the principles of equal treatment and proportionality;

- Appointed UDF Fund Managers being subject to some form of national financial regulation that requires them to operate in line with market investment principles, while still requiring them to achieve the relevant policy objectives of the UDF;

- The UDF having in place appropriate governance structures and investment processes and procedures (including obligations to ensure impartiality, and independence of the UDF Fund Manager and to prevent conflicts of interest);

- UDF Fund Manager remuneration operates, at least in part, on a performance related basis. See further details below in section 1.5.4 regarding manager remuneration; and

- Sufficient levels of monitoring and control in terms of investment decisions made at the UDF level are in place (including UDF Fund Manager carrying out hands-on monitoring at the Urban Project level).

Cumulation

There may be circumstances where Urban Projects that have received State Aid via investment made by a UDF may have also already received, or have applied for, State Aid from other sources (for example by way of grant funding). The Commission will expect provisions to be in place which ensure that private investors as a result do not obtain an unacceptably high rate of return (i.e. greater than the established fair rate of return (see the comments of proportionality in the table below).

Further potential areas of focus for a notification to the Commission

The process of a notification includes dialogue, clarification and challenge between the MA and the Commission. It is not a standardised process and the Commission is free to explore all areas within HF or UDF operations in order to satisfy itself of the necessity and appropriateness of the notified measures.

However, there are a number of areas which are particularly relevant to the approval of State Aid notifications for UDF operations which are explored below:

Urban Project/IPSUD assessment criteria	Each Urban Project that receives investment from the UDF must be within an IPSUD. The IPSUD will be required to demonstrate that it is aligned to Commission Strategic objectives and that : • The Urban Projects contained within it are in targeted urban areas; • It is underpinned by an urban socio-economic and environmental needs assessment to show demand for assets and services; • Contains or is part of a coherent development under the responsibility of a local authority (or other suitable public body); • The activities proposed by it are likely to support Urban Projects that contain Eligible Expenditure (as defined by a Member States OP); and In addition, the assessment must also consider the nature of likely beneficiaries – in terms of sector and size – no aid can be provided to a firm in difficulty.
Fair rate of return	• At the outset of a Urban Project the level of aid provided to other investors or

	Urban Projects must not result in higher than generally accepted market rate returns for them (known as a 'fair rate of return' or FRR). In addition the level of aid granted must take account of the UDF receiving, as a minimum, the initial value of its initial investment ("Financial Sustainability"); and • During the delivery of an Urban Project a suitable profit sharing mechanism must be in place to ensure the principles of a FRR are maintained. This could include sharing 'upside' profits between investors (including the UDF) and protecting a first loss exposure taken by the UDF in relation to an Urban Project.
Co-Investment	• The UDF may not finance an Urban Project without other market investors assuming a proportion of the investment risk. State Aid for Risk Capital (SARC) states that this level of Co-Investment must be significant (suggested to be not less than 30% in regional aid assisted areas and 50% in non-regional aid assisted areas); and • It is important to remember that other investors can invest in an Urban Project directly or through the UDF and that the level of OP resources are likely to be the main source of public resources available to the UDF for investment.
Urban Project selection by UDFs	• Section 2.2 of the Handbook provides details on the approach to good practice for UDF Urban Project selection; • In assessing any State Aid notification the Commission will review this to ensure the UDF is required to provide an inclusive process through which any and all Urban Projects can approach the UDF for investment – including assessing the way the UDF publicises its calls for Urban Projects. The selection process must then be demonstrated to be open and transparent to provide clarity around investment decisions by the UDF; and • Part of the decision making process should include a mechanism to assess

	non-financial or socio-economic metrics within a Urban Project and, through this mechanism, provide a rationale for accepting Urban Projects with lower rates of financial return that deliver higher socio-economic impacts within the IPSUD area.

The UDFs in the North West of the UK and in Andalucía in Spain benefit from approvals made by the Commission for them to provide aid. The wording from these notifications focuses on the processes and procedures of the UDF Fund Manager and not on the identified Urban Project investments that the UDF will make. Notifications for UDF operations are expected to continue with this focus ("a process and system notification"), which places responsibility on UDF Fund Managers to operate within the parameters set out in any notification received.

To that extent, the UDF receiving a notification will retain the flexibility to select Urban Projects that best fit within its investment strategy, while continuing to adhere to the constraints on its operations set out in the State Aid approval documents issued by the Commission.

Case Study – North West Urban Investment Fund

The UK authorities and the European Investment Bank set up the JESSICA Holding Fund for the North West of the UK – the 'North West Urban Investment Fund' ('NWUIF'). The NWUIF has appointed two UDFs – one focusing on the Merseyside sub-region (around the City of Liverpool) and the other covering the rest of the North West region (including the City of Manchester).

The investment strategy of the NWUIF, and its UDFs, is focused on two strategic objectives of the region's OP:

- Developing high quality sites and premises for businesses on 36 sites that are designated as strategically important for the region; and
- Bringing employment sites back into use in areas of high economic deprivation, set out by the Regional Economic Strategy as priority spatial areas.

The HF and UDF Fund Managers believed that the optimum selection of Urban Projects for investment by the UDFs would involve providing aid that could not be justified under existing State-aid provisions (e.g. Block Exemption Regulations).

Therefore, a notification application was made by the UK Government (with the support of the NWUIF and its two UDFs) to the Commission seeking approval of the proposed JESSICA Operation in order to allow it to operate so as to provide:

- Senior and subordinated loan products at below market rates and on non *Pari Passu* terms with private sector lenders;
- Equity and quasi equity on non *Pari Passu* terms with those applicable to private sector investors; and

- Grants on behalf of the UK Government to address continued viability gaps within Urban Projects even where non Pari Passu loans or investments were made.

The UK Government was granted the approval in July 2011 – which required the HF and UDFs to follow a number of practical procedures in the way UDF operations and Urban Project investments were undertaken. These included that:

- The Urban Project selection process employed by the UDFs must remain open and transparent;

- All Urban Projects must be viable (the UDF investment must be likely to be repaid at least the capital invested);

- Private investors must cover at least 50% of the total eligible Urban Project costs;

- A fair rate of return ("FRR") must be established for all investments in Urban Projects using either open procurement, competitive competition or independent experts to establish market rates. The FRR will provide evidence that no investor or beneficiary is receiving an excessively high return;

- UDFs may not use the same independent expert in terms of determining an FRR for Urban Projects more than twice in any period of 6 months and that expert must have no links to the UDF or the relevant Urban Project/Urban Project investor; and

- Monitoring and reporting procedures are required to include specific provisions with regard to the detailed obligations of the State Aid notification. The MA, HF and UDF have responsibilities in this process.

1.5.4 State Aid implications for fund manager fees

As previously indicated, in being an intermediary vehicle for the deployment of Structural Funds and other State resources to Urban Projects, UDFs may not be recipients of State Aid arising from JESSICA Operations. However, UDF Fund Managers receiving management fees for their services have the potential to be State Aid recipients and as such the basis on which they are remunerated must be compliant with State Aid rules.

If a UDF Fund Manager is procured through a competitive tender process in line with the requirements of Directive 2004/18 (*see Section 1.8 below*), the management fees paid to the UDF Fund Manager are normally considered to be in compliance with State Aid regulations (as the tender process will operate to as a benchmark in terms of the market rate of remuneration). The Commission Risk Capital Guidelines state that: *"there is a presumption of no aid if the managers or management company are chosen through an open and transparent public tender procedure or if they do not receive any other advantages granted by the State."*

1.6 Other ERDF Regulations

Urban Projects wishing to receive funding through the JESSICA initiative must comply with the requirements of the ERDF Regulations, subsidiary COCOF Guidance notes and the National rules governing the use of the ERDF resources in the region / country. As a financial engineering instrument operating under the JESSICA initiative, the UDF must be consistent with Commission regulations relating to Financial Engineering Instruments which include Articles 43-46 of The Implementing Regulation, Articles 44, 56 and 78 of the General Regulation, and Articles 3(2)(c), 4(1), 5(1)(d) and 6(2)(a) of Commission Regulation (EC) 1080/2006.

As noted earlier, the majority of the relevant ERDF Regulations are integrated across this UDF Handbook. The section that follows here indicates categories of regulations that may not naturally integrate into other sections but which are important for UDFs to be aware of. Each set of regulations is indicated with an italicised heading.

On the process for selecting HFs and UDFs

Article 44 of the General Regulation sets out the basis on which resources may be implemented but do not specifically refer to the procedures for selecting funds other than Holding Funds (*as indicated above in Section 1.1.5 - Options for Delivery*). *Further details on this point are set out in Section 1.8 - procurement - below.*

On eligible expenditure and In-kind Contributions

Articles 56 and 78 of the General Regulation relate to eligible expenditure (including In kind contributions - see section 1.4.3 above) and Statements of Expenditure (*see Sections 1.1.3-1.1.4, 1.3.3, 1.3.5, 1.4.1 - 1.4.3, 3.2-3.4 and 1.4.3*).

On the scope of assistance allowable for Financial Engineering Instruments

Article 3(2) (c) of Commission Regulation (EC) 1080/2006 refers to the scope of assistance in terms of ERDF including venture capital, Loan and Guarantee funds.

On Structural Fund priorities

Articles 4(1) and 5(1) (d) of Commission Regulation (EC) 1080/2006 refer respectively to (1) convergence objectives covering public private partnerships (Article 4(1)); and (2) regional competitive and employment objectives including creation of Financial Engineering Instruments (Article 5(1) (d).

On eligible expenditure for revenue generating projects and the inapplicability of Article 55of the General Regulation.

Article 55 of the General Regulation covers the treatment of Urban Projects receiving ERDF resources that generate revenues, stating that: "*Eligible expenditure on revenue generating projects shall not exceed the current value of the investment cost less the net revenue from the investment over a specific reference period…"*

It is expressly stated, however, in section 8.4 of COCOF Note 3 that: *"Paragraphs 1 to 5 of Article 55 of the General Regulation do not apply to Financial Engineering Instruments within the meaning of Article 44 of the same General Regulation and Section 8 of the Implementing Regulation".*

On this basis, the requirements under Article 55 of the General Regulation do not need to be applied to revenues generated by UDFs on investments made in Urban Projects (or through any

Idle Resources investment policy) or the underlying investments in Urban Projects that the UDF makes.

1.7 Governance of UDFs and Investments

The role of governance is a key factor in the structure and on-going management of the UDFs and from that perspective, the governance rules and processes will:

- Set the parameters for the UDF Operation;
- Provide clarity around the decision making process (e.g. investment decisions);
- Establish Urban Project governance principles (investment policies, and any approvals processes); and
- Outline any additional management and control procedures (e.g. management of risk strategies, and the process for escalating issues that arise in the delivery of UDF operations by the UDF Fund Manager to the MA / HF).

These areas are developed in detail in *Section 2.1.3*, but are initially considered as part of the Preliminary Steps to assist the UDF Manager in understanding the role of UDFs in the governance structure – to include Urban Project appraisals, investment and performance monitoring, and compliance with investor requirements (e.g. bank covenants).

The Structural Funds regulations do not impose a requirement for a particular governance structure, but any such structure will need to be consistent with the requirements set out within those regulations regarding the operation of Financial Engineering Instruments. In particular, the UDF is required to operate in compliance with the State Aid and procurement rules and take necessary steps to comply with document retention requirements for monitoring, verification and audit requirements. (*Section 4 of this handbook outlines the requirements and provides sample processes for monitoring, auditing and reporting, which may inform the initial development of JESSICA governance standards. The HF Handbook also provides reference to the interaction between MAs, HFs and UDFs which can also inform the development of governance processes).*

National rules will also be relevant and will be dependent on the structure adopted for the JESSICA Operation. These will include rules in the Member State governing investment (e.g. ensuring that the UDF has secured all necessary licences permits, registrations etc, to enable it to operate the fund) as well as other areas such a Data Protection. Obligations in terms of compliance with such requirements should be clearly set out in the Level II Funding Agreement.

1.8 Procurement of UDFs

Regarding the selection of UDFs COCOF Note 3 states:

"The General Regulation and the Implementing Regulation do not set out specific provisions for selecting funds other than holding funds. Managing authorities and holding funds must assess whether their contribution to a financial engineering instrument (as described in the first paragraph points (a) (b) and (c) of Article 44 of the General Regulation) is a procurement of services governed by EU or applicable national public procurement law and comply with any such applicable law".

A thorough assessment will need to be undertaken by each HF/MA in order to select and appoint a UDF. UDF Fund Managers should be selected using a competitive procurement process that conforms to EU and, if applicable, local procurement laws. A formal competitive public procurement with OJEU publication is not a necessity for all circumstances, but special care and knowledge of appropriate practice under EU public procurement law and relevant jurisprudence may be required for cases where such formal public procurement with OJEU publication is not used. An open and transparent selection process will also ensure that the level of UDF Fund Manager fees have been competitively tested and thus conform to prevailing market rates for the type of service to be provided.

As part of the selection process, the UDF Fund Manager should be able to demonstrate in their Business Plan that the Urban Projects proposed for investment are aligned to the requirements of the OP and the IPSUD.

Once the preferred JESSICA Operation has been approved, the HF/MA will consider establishing a procurement procedure though which the UDF operator(s) will be identified and appointed. The detailed UDF set up and appraisal processes to be undertaken are set out in Section 2.1 – the focus of this stage is to recognise the rules and parameters that will shape the procurement process to be established by the HF/MA, prior to selecting the UDF(s). *(The HF Handbook also provides reference to procurement rules relating to UDF selection).*

COCOF/08/0002/03 "Guidance note No 2 on financial engineering", Section 1.2, outlines the differing factors that distinguish grants from public procurement contracts. These factors are outlined in the box below. HFs/MAs will need to consider these factors when establishing a process for UDF selection.

COCOF/08/0002/03 "Guidance note No 2 on financial engineering", Section 1.2
Differing Features of Public Contracts v. Grants

In general, a Public Contract will have the following features:

- A product or service is procured, by a contracting authority (or entity) for needs falling within its remit in return for consideration (i.e. price or other consideration);
- The terms of the service or product are set out in detail by the contracting authority in the tender documents;
- The successful tenderer will be contractually bound to comply with the terms of the award;
- The contracting authority or entities will normally bear 100% of the contract consideration;
- The contract is bilateral: it imposes reciprocal obligations on the contracting authority and the product or service provider, with the latter providing the contracting authority or a third party or parties designated by it with the product or service it has ordered. The contracting authority monitors provision of the product or service it has ordered;
- The result of a procurement procedure is a contract.

In general, a grant will have the following features:

- A contribution is made either to an action or Urban Project carried out by a grantee which falls primarily within the scope of the grantee's activities or direct to the grantee because its activities contribute to policy aims of the grantor, such action or Urban Project of the grantee normally being in the interest of the grantor;
- The application for financing originates with the grantee, who submits a proposal for support for activities it is carrying out or plans to carry out; its proposal sets out the specifications for the action to be performed, which may be within a pre-set legal or other framework laid down in advance by the grantor;

- Ownership will normally remain with the grantee, although it is possible in some cases for the financial contribution to revert to the grantor at the end of an action;
- The grant does not necessarily finance the total cost of the action;
- The financial contribution of the grantor should not be in consideration of any product or service provided by the grantee to the grantor;
- Conditions can be attached to the grant awarded, but there is no direct and specific link between individual obligations on either side (grantor and grantee), although the grantor has the right to monitor technical implementation of the action and the use made of the resources granted;
- The grant must not have the purpose or effect of producing a profit for the grantee;
- The outcome of a grant award procedure is a grant agreement or a grant decision.

The guidance states that "*National authorities will have to ascertain, on a case-by-case basis, whether the structure they are planning to implement is a grant or a public procurement and it is their responsibility to comply with any and all applicable laws*". In delivering the JESSICA initiative, a significant number of MAs and HFs have thus far opted to use a procurement process for the selection of UDFs.

When a procurement process is deemed necessary for UDF selection, MAs/HFs will need to consider which process to utilise based on the requirements of Directive 2004/18/EC as enacted into the applicable national law. The Directive 2004/18/EC sets out a number of award procedures, which are as follows:

- ***Open Procedure –*** This provides that all those interested in the matter advertised in the OJEU may respond to the advertisement by tendering for the contract.

- ***Restricted Procedure –*** This process selects an initial list of applicants through a review of pre-qualification questionnaire ("PQQ") responses. The opportunity will need to be initially advertised on OJEU and only the selected entities from the PQQ stage are invited to submit a tender for the contract. The benefit of this approach is that it avoids the need to deal with a large number of tenders.

- ***Competitive Dialogue Procedure –*** Following the issue of an OJEU Contract Notice and a selection process based on PQQ responses, a dialogue with selected potential bidders commences. The purpose of the dialogue is to develop one or more suitable solutions for required services, and to select a final set of bidders who are invited to tender.

- ***Negotiated procedure*** – Here the purchaser of the services may select one or more potential bidders with whom they will then negotiate with respect of the contract. An advertisement in the OJEU is usually required but, in certain circumstances described in the regulations, the contract does not have to be advertised in the OJEU. An example is when, for technical or artistic reasons or because of the protection of exclusive rights, the contract can only be carried out by a particular bidder.

Due to the restrictions that apply for the use of the Competitive Dialogue and Negotiated Procedures[26] and the nature of the Operation at the UDF level, these are not presently used for selecting UDF operations. Where a public procurement is required, the most commonly utilised procedure in terms of fund operation and management is the **Restricted Procedure**.

[26] As set out within Article 28 to Article 31 of Directive 2004/18

When carrying out the procurement process, MAs/HFs will need to abide by the Directive 2004/18 (as enacted into the relevant national law). Remedies for failure to abide by these regulations are outlined in Directive 89/665/EC, as amended by Directive 2007/65/EC (the Remedies Directive). It states that action can be taken by the Commission against Member States or by suppliers etc. against the contracting entity in national Courts.

Finally, it is important to note that in the absence of an HF, the Programme Monitoring Committee of the OP may be required to approve the criteria for selecting a UDF, and may thus need to be involved in the tender process. Details of the obligations that the Programme Monitoring Committee has for satisfying itself that the OP is being implemented in an effective and quality manner are outlined in Article 65(a) of the General Regulation and in Section 8.2 of COCOF Note 3.

Once a UDF is selected through the procurement process, it will need to ensure compliance with Commission and national guidelines, as well as the terms of the contract. The provisions of COCOF 07/0037/03 "Guidelines for determining financial corrections to be made to expenditure co-financed by Structural Funds or the Cohesion Fund for non-compliance with the rules on public procurements" provide for claw back of Structural Funds where these are applied in an manner that breaches the requirements of Directive 2004/18/EC or the general transparency requirement under the TFEU.

By way of example, COCOF note 07/0037/03 provides for a recommended recovery of 100% of the value of the contracts involved where there is *"non-compliance with the advertising procedures"* where such a contract is fully subject to the public procurements directives and up to 10% of the value of the contract (which are not fully covered by the public procurement regulations, e.g. Part B services or below threshold) where there is a breach of the principle of equal treatment.

(*MAs have the option to not utilise a procurement process, however this has implications for State Aid compliance. See section 1.5.1 above on State Aid Implications for UDF Set-Up for full detail on State Aid compliance issues when a procurement process is not utilised.)*

1.9 Drawing Down OP Resources into UDFs

The initial draw down of ERDF resources into a HF or UDF can be made prior to actual qualifying investments made at Final Recipient level by the UDF. This is possible on the basis of the being Article 78(6) of the General Regulation which states that: *"...as regards Financial Engineering Instrument as defined in Article 44, the statement of expenditure shall include the total expenditure in establishing or contributing to such funds or holding funds".*

Following the procurement of a UDF, the UDF will need to adhere to conditions and requirements for drawing down ERDF resources into a UDF. For instance HFs are allocated ERDF resources through interim certification by the MA.

Article 78 of the General Regulation outlines the requirements for the general certification of expenditure made through an OP (in that resources cannot typically leave an OP until evidence of their expenditure has been provided by the Final Recipient). Paragraph 6 of the same Article defines the special provisions made for Financial Engineering Instruments (as defined by Article 44 of the General Regulation to draw down OP resources in advance of expenditure), which allows the interim certification of OP expenditure at the time resources are drawn from the OP to set up the Financial Engineering Instrument (this may be in forming the HF, or Urban

Development where no HF is used). This interim certification relates to OP resources and will therefore require the MA to be reasonably satisfied that appropriate National Co-financing is evidenced.

Article 78.6 of the General Regulation does not require any further certification of expenditure for the Financial Engineering Instrument until the end of 2015 when OP closure is undertaken (in the case of a partial early closure of an OP by a MA, this date may be earlier). This process of final certification at OP closure requires the UDF to evidence it has invested OP resources into Urban Projects, which is likely to be evidenced by Investment Agreements with final recipients and a review of bank statements to show the money has passed out of the UDF accounts into that of final recipients.

2. PRE-INVESTMENT PROCESSES

Setting-up a UDF will normally take place under the supervision of the MA, or the HF acting on behalf of the MA. The process of setting up a UDF includes a series of pre-investment activities which provides the HF/MA with the opportunity to assess the suitability of proposed UDFs to deliver against the local OP requirements and aims of any formulated investment strategies for an HF or UDF (as outlined in Sections 1.2 and 1.3).

The process of selecting a UDF will include an assessment of UDF Fund Manager capability by reference to past experience, suitability of proposed governance structures to meet the requirements of the ERDF Regulations and good practice for the management of Financial Engineering Instruments, the suitability and deliverability of Urban Projects proposed to be delivered in the early rounds of the UDFs investment activities and the potential for UDFs to recycle resources in the long run to enable a sustainable fund with legacy activity beyond the current programming period.

2.1 UDF Set-Up

The initial set-up and selection of UDFs is managed and approved by the MA or the HF (where one has been established), which will include the selection of a procurement process selected based on the target UDF Typology (outlined in Section 3.1.2.1 of the HF Handbook) and the level of competition of potential candidates.

In characterising different fund models, based on the existing UDFs currently operating in Europe, three key categorisation criteria can be applied to UDFs *(as referenced in the UDF Typologies Study)*:

- the nature of UDF business strategy – the possible types of urban investment projects to be financed by the fund *(Section 2.1, UDF Typologies Study, page 14)*

- the nature of financial products for the envisaged financial recipients – reflecting the cash flow structures of the Urban Projects invested and how the UDF will apply any or all Guarantees, Loan and/or Equity products available through a JESSICA structure *(Section 2.2, UDF Typologies Study, page 24)*

- the nature of the UDF governance structure – depending for instance on the number and type of parties involved and the choice to adopt either a corporate governance structure or a public administration governance structure *(Section 2.3, UDF Typologies Study, page 36).*

The combination of these three key dimensions provides the HF/MA with potential UDF prototypes, within which the HF/MA may have a preference when structuring the UDF selection process (e.g. typology characteristics could be used to define criteria for candidate assessment). Once a procurement procedure is chosen, the selection and negotiation with UDF(s) begins. The process is typically launched with an initial Call for Tenders followed by invitations to submit Business Plans evaluated against award criteria.

UDF applicants who meet the HF/MA quantitative and qualitative conditions within the procurement evaluation subsequently enter into negotiations with the HF/MA who conduct additional due diligence, with the aim of refining the proposed UDF Business Plan and agreeing contract for the receipt of OP resources. The contract for receipt of OP resources by the UDF from the HF/MA is referred to as the Level II Funding Agreement.

The finalisation of the agreement will be based on detailed negotiations between the HF/MA and UDF, including further agreement on the investment actions required to deliver OP resources. In the case of where an HF is used, the proposed UDF Fund Manager will also be required to reflect any of the conditions of agreements between the MA and HF in its operational and investment Business Plans.

2.1.1 The UDF Business Plan

The purpose of a UDF Business Plan is to define the objectives of the UDF, its investment targets and its approach for delivering investments. In effect, the Investment Strategy defines what the UDF will invest in and the Business Plan sets out how this will be done. The Business Plan will be developed by the UDF during the procurement and selection process and then further refined as the UDF Fund Manager becomes the preferred then the selected provider for the HF/MA.

The aim of this section is to first outline the requirements of the regulations that should be considered during Business Plan development and then to explore the basic components which make up the UDF's Business Plan.

There are minimal regulations governing UDF Business Plan development and those defined are mostly articulated for Holding Funds within Article 44 of the General Regulation. However, COCOF Note 3 makes it clear that those requirements also apply to non-Holding Fund structures utilised for the delivery of Structural Funds (i.e. a UDF). The relevant regulations are as follows:

- Article 44 of the General Regulation on the approach to UDF Business Plan strategy (or Business Plan) – the UDF Business Plan needs to define the UDF's link to the requirements of the NSRF, the OP and the IPSUD, as well as the Eligibility Rules set out in Article 56 of the same regulation. These regulations require adherence to the eligibility rules of both the Commission and national governments.

- Article 46 (2) of the Implementing Regulation on the "Nature of Financial Products" – UDFs need to ensure compliance with State Aid rules in respect of the investment products which they intend to use. State Aid compliance must also be articulated in the Business Plan.

- Provisions of COCOF 07/0037/03 "Guidelines for determining financial corrections to be made to expenditure co-financed by Structural Funds or the Cohesion Fund for non-compliance with the rules on public procurements" – UDFs need to comply with regulations of public procurement and ensure adherence to contract requirements developed after a successful tender. The Business Plan will need to articulate how it will enable compliance to these regulations and demonstrate its understanding of the 'claw back' risks in the case of any breaches to the requirements of Directive 2004/18/EC or the general transparency requirement under the TFEU.

Basic Components of a UDF Business Plan

The UDF Investment Strategy (outlined in detail on Section 1.3) is a core component of the UDF Business Plan. It sets the agenda for UDF operations and the allocation of OP resources (ERDF and National Co-financing) into Urban Projects. The remainder of the UDF Business Plan is focused around the delivery of the Investment Strategy and the operations of the UDF, covering items such as legal ownership and governance structures, Management Costs and Management Fees, and winding-up provisions.

The following outlines the key components of the Business Plan. The order and depth of detail required for each of these components may vary across regions depending on what is required by individual MAs/HFs. *Sections 1.2 and 1.8 of this document include details relevant to several of the components below, and should be reviewed in conjunction with this Business Plan section.*

- **UDF Investment Strategy** – Outlines the investment objectives of the UDF, summarises the portfolio of potential Urban Projects including the methodology of selection, and provides preliminary detail on expected Income Receipts and Capital Receipts, first and second round investment principles, and exit strategies. This section also includes a discussion on how regulatory issues are to be addressed, including State Aid.

- **Investment Period** – the proposed life span of the UDF, which informs the timescales for investment, Income Receipts, Capital Receipts, the scope for recycling in subsequent investments, and Exit Strategy.

- **National Co-financing** – A discussion of expected National Co-financing and other in-kind public National Co-financing contributions. This section should include verification of these expected contributions and any expected 'swapping' of contributions at the Urban Project level.

- **Additional Public and Private Co-Investment –** A discussion of other expected public and private co-financing.

- **Financial Forecasts –** Outlines in detail the initial financial estimates for the UDF based on Urban Projects information (including underlying assumptions about their projected Income Receipts and Capital Receipts) and other costs and fees for the operation of the UDF. It includes detail on the financial model used, the nature of investments (Loans, Equity, Guarantees), and processes for credit scoring, investment drawdown, and investment repayment.

- **Legal and Ownership Structure of the UDF –** Describes the legal and ownership structure of the UDF including the rationale for the structure.

- **Governance Structure** – Describes the proposed UDF governance and management structure including the key functions for investment portfolio management, fund management, and overall programme oversight. This section also describes how these functions need to work in concert with one another including any checks and balances. *Additional discussion on governance issues is included in Section 2.3, page 36 of the UDF Typologies Study.*

- **Management Team –** Presents the proposed management team, their responsibilities and their qualifications for their respective roles.

- **Management Costs and Management Fees** – Outlines the proposed level of fees payable to a UDF, including a proposed fee structure and calculations. Costs and fees include those for UDF set-up and operations, as well as any performance based fees. *Detail on the requirements for Management Costs and Management Fees are described in Section 5.*

- **Other Operating and Control Procedures** – Describes the procedures for monitoring, auditing and reporting required to ensure regulatory compliance and regular assessment of Urban Project progress. It includes details on other necessary activities such as marketing, risk management, and stakeholder engagement, defined in line with regulatory requirements.

- **Winding-Up Provisions and Re-utilisation of Resources –** Discusses plans for first and Follow-on Investments, as well as exit strategies. This section may be integrated within the Investment Strategy or discussed in detail in a separate section.

This list covers basic components of a UDF Business Plan, but components may vary depending on the type of UDF applicant (e.g. existing financial vehicle or a newly established entity) and the criteria for selection put forth by the HF/MA as a part of the procurement process. *Section 3.1.2.3.3, pages 39-42, of the HF Handbook* indicates some the assessment criteria which HFs may apply to a review of UDF Business Plans.

2.1.2 Level II Funding Agreement

The exact form and structure of Funding Agreements is not defined in detail in the regulations, however Section 2.4 of the COCOF Note 3 provides what can be considered to be minimum requirements, on the basis of Articles 43(3) and 44 of the Implementing Regulation. The Level II Funding Agreement is the contractual basis for the UDF receiving OP resources from the HF/MA and is usually negotiated between the UDF and HF/MA as part of finalising the procurement process for UDFs.

At this point, the UDF will have provided detailed information to the HF/MA as part of the procurement process and the Level II Funding Agreement will enshrine in contract form those elements for which the HF/MA require certainty of delivery from the UDF as a condition of it being appointed, including:

- Priorities for investment in Urban Projects that meet the eligibility criteria of the OP;

- The type and details of the investment product the UDF will offer – i.e. Loan, Equity or Guarantee;

- The timescale over which investment resources will be deployed by the UDF;

- The duration over which the UDF will have use of the OP resources from the HF/MA;

- Supporting monitoring and audit activities required from the OP;

- Quality of staff resources the UDF will utilise to source, negotiate and monitor investment Urban Projects.

The agreement will also include the rights and obligations of the UDF and the UDF Fund Manager; the financial conditions that will apply to the OP resource made available to the UDF; and, the liabilities that the UDF and the UDF Fund Manager will assume in event of default.

Operating in line with a Business Plan, including implementation of a required Investment Strategy that complies with the OP, which is approved by the HF/MA, should be an obligation within the Level II Funding Agreement.

Article 43 (3) of the Implementing Regulation refers to the following minimum requirements of a Level II Funding Agreement for the transfer of OP resources from a HF/MA to UDF:

- Set out the Investment Strategy;

- Detail the provisions for monitoring of implementation;

- Set an exit policy for the contribution from the OP out of the Financial Engineering Instrument;

- Clear provisions for the winding-up of the financial engineering instrument, including the reutilisation of resources returned to the financial engineering instrument from investments or left over after all guarantees have been honoured that are attributable to the contribution from the OP.

It is also important to consider the certification of ERDF resources at the point the UDF is established, when it is likely that ERDF and National Co-financing resource will be drawn into the UDF. Section 1.9 provides detail on this certification process.

As previously indicated, obligations regarding compliance with relevant wider EU-level requirements, such as State Aid and procurement should also be incorporated into the Level II Funding Agreement, as should obligations to enable that the HF/MA is able to ensure the UDF helps it comply with obligations relating, for example, to publicity, monitoring, verification and audit, or separation of accounts. If granting of State Aid cannot be excluded, a possible alteration of the Level II Funding Agreement due to State Aid issues raised during negotiations with the Commission should be foreseen.

COCOF Note 3 further elaborates the regulations by stating that a Funding Agreement should also incorporate the following elements;

- The terms and conditions for making contributions from the OP to the Holding Fund and to the Financial Engineering Instruments;

- The Investment Strategy or policy and target recipients and actions (enterprises, urban development projects, renewable energy/energy efficiency schemes, etc.);

- The financial engineering products / instruments to be supported;

- The exit policy for the OP contribution to the Financial Engineering Instrument(s) concerned;

- The winding-up provisions for the Financial Engineering Instrument(s) including for the re-utilisation of resources returned from investments made or left over after all Guarantees have been honoured, attributable to the contribution from the OP.

- Monitoring of the implementation of investments and of deal flows including reporting by the Financial Engineering Instruments to the Holding Fund and/or the Managing Authority;

- Audit requirements, such as minimum requirements for documentation to be kept at the level of the Financial Engineering Instruments and at the level of the Holding Fund in order to ensure a clear audit trail, including provisions and requirements regarding access to documents by national audit authorities, Commission auditors and European Court of Auditors.

COCOF Note 3 also recommends inclusion of the following additional provisions to those set out in the regulations:

- Requirements and procedures for managing the financial proceeds provided by the OPs (including where applicable provisions for the phased transfer of resources based on agreements signed with financial intermediaries and forecasts of deals flows);

- Treasury management of resources and counterparty risks, including type of acceptable treasury operations/investments, responsibilities and liabilities by parties concerned, record keeping and reporting, etc.;

- Provisions regarding the utilisation of interests and other Gains generated by payments from the OP to the Financial Engineering Instruments concerned and for the utilisation of Income Receipts and Capital Receipts in compliance with Article 78(7) of the General Regulation and Article 43(5) of the Implementing Regulation.

This section will provide detail on the above requirements as well as other relevant rights and obligations between the UDF and the HF/MA. It will also outline the steps for negotiating and concluding the Level II Funding Agreement including a description of key players, due diligence requirements for the UDF and next steps following the signature of the agreement.

Structure of the Level II Funding Agreement

The following topics are expected to be covered by a Level II Funding Agreement:

- Rights and obligations of the UDF Fund Manager
- Disbursement of ERDF resources
- Obligations pertaining to Investment Agreements
- Repayment of the investment from the UDF to the HF/MA
- Security required for OP resources
- Treasury management processes
- Charges and expenses claimed by the UDF
- Events of default – UDF and Urban Project events
- Approach to governance (e.g. forming an Investment Committee and the reporting or approvals process)
- Investment processes for selecting and contracting with Urban Projects

- Credit Assessment
- Risk Management
- Reporting requirements to the HF/MA

2.1.3 Approach to UDF Governance by HF/MA

The regulatory framework does not require an approach for UDF governance structure but the responsibilities inherent within EU regulations and Regional OPs mean that MAs (or HFs, if they exist), will need to conduct oversight activities over UDFs. UDF Fund Managers will be required to submit their activities to MAs/HFs for scrutiny.

National rules on the operation of Financial Engineering Instruments may also be relevant and will impact on the structure adopted. These will include rules from the MS governing investment (e.g. all necessary licences permits or registrations to operate the fund) as well as other areas such as data protection. Obligation in terms of compliance with these requirements should be clearly set out in the Level II Funding Agreement.

Common practice is for the HF/MA to establish this governance structure as part of the preparation for setting up JESSICA Operations, usually through a single entity of governance commonly called the 'Investment Committee' (see also 3.1.1.2 in the Holding Fund Handbook).

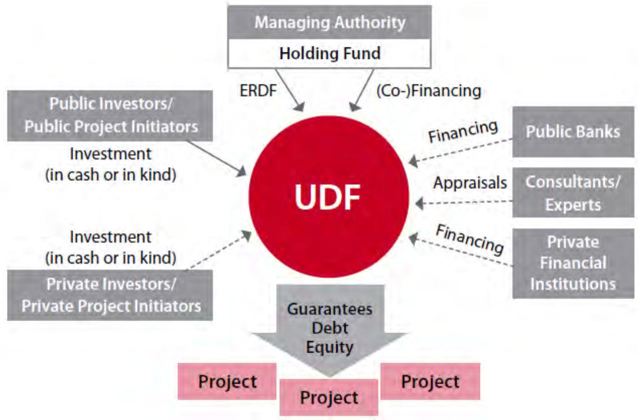
The Investment Committee will monitor the UDF either directly (in the case where there is no HF in place) or through the processes it has in place to govern the activities of the HF. Once a UDF is selected, the Investment Committee (either directly or through the HF) will carry out the following governance tasks over a UDF's activities:

- Review the progress of the UDF Investment Strategy, including performance of Urban Projects already invested in by the UDF and planned pipeline of future investments, to ensure it meets with the general investment aims of the OP;

- Review monitoring information and provide instruction to the UDF for changes to its operations or investment plans if necessary from the review of this information;

- Approve changes to the structure or activities of the UDF – such as changes to key UDF personnel.

The UDF Typologies Study discusses in Section 2.3 the main dimensions of UDF governance structures and the parties involved in its governance – the diagram below is taken from the UDF Typologies Study document.



The governance processes outlined above (and discussed further in the HF Handbook and UDF Typologies Study) are intended to set parameters for UDF Operation including decision making structures and participants (e.g. Investment Committees, board of directors, specialist advisors), Urban Project governance principles (e.g. lending policies, Loan approval strategies, delivery strategies), and other management and control procedures.

The internal functions of a UDF therefore have to be aligned to meeting the external governance demands, including specified roles and responsibilities for the personnel operating the UDF, how they relate to the general investment activities of the UDF and other obligation imposed on the UDF through corporate reporting or financial accountability arising from the legal or regulatory conditions in its country of operation.

2.2 Urban Project Investment Decision Making by UDFs

At this stage of the pre-investment process, the UDF will have a Level II Funding Agreement from the HF/MA that contains a specific remit to deliver investment resources into a range of Urban Projects that meet the criteria of the OP. As a first stage, UDFs will need to develop an initial list of target Urban Projects for investment proposed during the period in which the UDF was being appointed and advance this to a series of 'investment ready' propositions. Typically, this will require an iterative Urban Project review which begins with the engagement of potential Urban Project implementing bodies to develop an initial pool of Urban Projects, followed by a detailed selection and evaluation exercise to sift for an initial list of candidate Urban Projects.

The finalisation of these Urban Projects as first wave investments will be determined by the UDF, during which Investment Agreements are negotiated and signed with Urban Project counterparts after suitable approvals have been given to the UDF by its Investment Committee (or HF/MA).

2.2.1 Initial Identification of Urban Projects ('call for Urban Projects')

The initial identification of potential Urban Projects that could be suitable for funding by a UDF first occurs at a high level during the initial JESSICA Evaluation Study (as outlined in Chapter 1.1.2), which is then updated during process of procurement for UDFs (UDF bidders should be expected to review the Urban Projects identified during the JESSICA Evaluation Study as well as identifying addition Urban Projects they are aware of). UDF Fund Managers, early in their appointment, should begin a process of marketing the UDF (often through 'call for Urban Projects' requesting Urban Project proposals from a variety of promoters) and undertaking a first appraisal of Urban Project expressions of interest received. UDF Fund Managers must inform potential Urban Project candidates in an appropriate open and non-discriminatory way about the possibility to receive UDF funding.

Any pre-appraisal will need to be consistent with the OP and the IPSUD, as well as the State Aid rules and the Eligibility Rules referred to in Article 56 of the General Regulation and applicable national eligibility rules as referred to in Article 56 (4) of the General Regulation. This in turn links into the Business Plan that must be developed in accordance with Article 43(2) of the Implementing Regulation.

First Round Investments by the UDF (in order to qualify as Eligible Expenditure) under any JESSICA Operation may only be in the form of Equity, Loans or Guarantees in Public Private Partnerships (PPPs) or other Urban Projects included in an IPSUD. First Round Investments may not be made in PPPs or Urban Projects relating to the creation and development of Loan or Guarantee funds.

Therefore, the aim for Urban Project call is to construct a suitable Urban Project portfolio, compliant with the regulations, from which the UDF can organise Investment Agreements with Urban Project promoters. This initial sift of Urban Project proposals will provide the UDF Fund Manager with a short list of Urban Projects to invest further time and resource in more detailed due diligence (prior to any Investment Agreement).

The Urban Project call process can be summarised to include:

- Marketing the UDF to help stakeholders understand what eligible activities the UDF can invest in, and how that investment can be made(by Loan, Equity or Guarantee);

- Engaging potential Urban Project implementing bodies including public authorities, public and private promoters or PPPs to determine if the UDF can invest in their Urban Project proposals;

- Collating the Urban Project information within the expressions of interest submitted to produce an initial portfolio of Urban Projects eligible for investment ; and

- Reviewing the Business Plans for the most potentially eligible Urban Projects.

Clarification of target Urban Project investments

In advance of any marketing activities, the UDF should define the initial parameters of its investment focus so that it can clearly articulate the type of Urban Projects it is seeking to support. This initial targeting will be based on the guidance provided by the IPSUD. Section 2 of the UDF Typologies Study proposes some key dimensions to target UDF Urban Project selection:

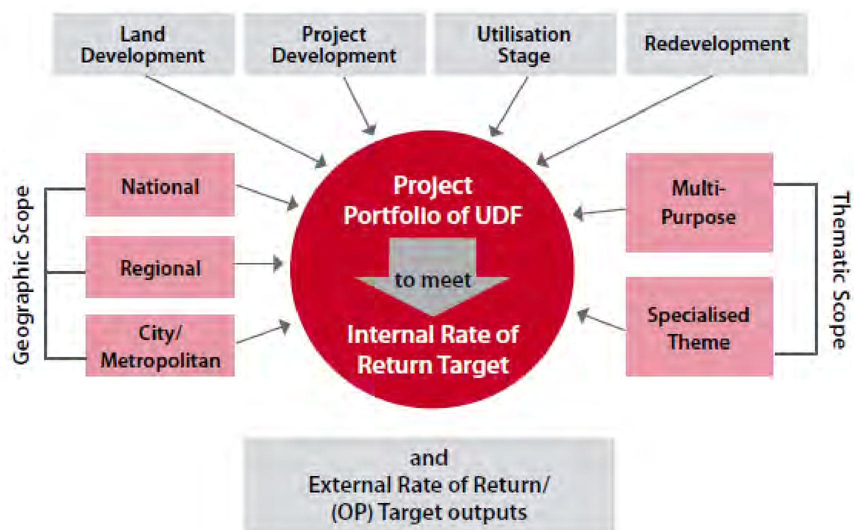
- A geographic area of focus should be defined;

- A planning-led approach for the UDF Investment Strategy should be defined that justifies the need for publically-funded investment for every Urban Project; and

- The proposed criteria for investment from both a financial and wider economic perspective (informed by the market demand analysis and socio-economic objectives considered within the JESSICA Evaluation Study).

In addition, the UDF should begin to interpret the financial performance requirements of its own Investment Strategy, as agreed with the HF/MA to further explain the nature of Urban Projects the UDF wishes to support. Typically, this will include assessing the expected rates of return targeted by the UDF, the amount of OP resources available for investment by the UDF and the duration which those resources are under management by the UDF.

The diagram below is taken from the UDF Typologies Study – it shows the range of issues the UDF must consider as part of determining its Urban Project investment priorities. The diagram below is taken from UDF Typologies Study.



Marketing activity

Having outlined Urban Project investment requirements, the UDF should undertake marketing activities as part of the process of identifying Urban Projects. The exact nature of this marketing activity should be defined locally by the UDF Fund Manager to reflect the quality and impact of existing marketing efforts undertaken to date by the HF/MA, levels of understanding about the JESSICA mechanism within the Urban Project delivery community and expectations of the Urban Project promoters who will come forward through the marketing efforts.

Examples of marketing undertaken by UDFs across the EU include:

- Media advertising, including TV and radio to a wide general audience – this is particularly helpful when there are no effective sector or organisational forums (such as Chambers of Commerce) to focus marketing efforts to;

- Regional or city open meetings with a combination of ‘open door’ and ‘invitations to likely interested parties’. Usually these events involve a presentation by the UDF of its

Investment Strategy and required Urban Project priorities, followed by a question and answer session;

- Targeted individual meetings on specific Urban Projects that were identified during the feasibility and set up phase of the JESSICA initiative or, from the UDF Fund Manager's own experience, identified subsequently as being strong possibilities for UDF investment;

- Meetings with representatives of public sector economic development agencies to review existing Urban Project pipelines and identify where JESSICA UDFs can play a role in on-going local development activities;

- Meetings with other investors groups, with the objective of introducing UDF funding into existing syndicates of funders who support urban development Urban Projects in a city or region.

Collecting Initial Urban Project Information

Typically during (or closely following) the marketing activities, the UDF should begin to assemble some information on the Urban Project that enables an initial assessment of an Urban Project's suitability to receive UDF resources.

- Urban Project detail – providing an overview of the Urban Project and giving the UDF Fund Manager the ability to assess if it meets the requirements of the OP and IPSUDs relevant to the UDF;

- Capital works – allow the UDF Fund Manager to understand the scale of the investment sought from the UDF and the contributions from other funders, plus the timing of those investments and their fit with the UDF's objectives to invest its resources;

- Type of UDF financial product most suitable to Urban Project needs – Loan, Equity or Guarantee (to be considered in the context of the legal form of the UDF, and the type of financial product(s) it will employ);

- Revenue potential – to allow the UDF Fund Manager to understand the sources of revenue generated to repay its investment and undertake an initial assessment of the risks associated with those sources. This information will also help the UDF understand including start and end dates for the Urban Project and timing of repayment of the UDF investment to ensure the Urban Project can be supported through UDF resources;

- Overall financial appraisal – illustrating the position of the UDF investment in financing the Urban Project and outlining how that investment will be repaid alongside the other investors. The analysis should also help the UDF Fund Manager understand the Urban Project IRR and general profitability to compare with any objectives set in the UDF Investment Strategy;

- Socio-economic / non-financial performance – which will include an assessment of the Urban Project's contribution to the economic development objectives of the prevailing IPSUD and the OP generally. In helping to measure an Urban Project's support to the non-financial aspirations for social or economic development, a scoring system could be developed for a number of criteria (such as job creation, square metres of building redevelopment or square metres of urban space regenerated). Comparing the scores for a number of Urban Projects under consideration by the UDF for investment can help justify the selection of Urban Projects and the rationale for providing aid to those Urban Projects (in the case where the UDF is deemed to be providing State Aid);

- Delivery structure – allowing the UDF Fund Manager to understand how the Urban Project will be delivered, who are the organisations involved in its delivery and the governance and oversight mechanisms. This will enable an initial assessment of the credibility of the Urban Project delivery team by the UDF and establish if any risks around their reputation or competency need to be addressed in future Investment Agreements.

UDF Business Plan Development

At this stage the UDF has the option to update portions of its Business Plan, agreed between it and the HF/MA. These changes may reflect:

- Expected outputs / impacts to be generated through UDF investments;
- Quantum of investment resources needed to be available for the UDF;
- Nature of investment resources to be deployed – e.g. Loan, Equity or Guarantee;
- Timing of Disbursements to be made from the HF/MA to the UDF;
- Any additional approvals or sign offs the HF/MA may wish to provide for some or the entire Urban Project portfolio;
- Diversification of the Urban Project portfolio of the UDF to mitigate risks associated to geography, sectors and industry trends;
- Risk adjusted return for the individual Urban Projects, taking into account e.g. occupancy risk, construction risk, exit/value risk;
- Output value for money (cash invested per output measure);
- Exit timescale for the UDF to receive Income Receipts and Capital Receipts and beginning to plan for Follow-on Investments;
- Market need and funding gap illustrating why 100% of the investment resources for the Urban Project cannot come from the market.

2.2.2 Selection, Evaluation and Structuring of Urban Projects

After the initial survey or call for Urban Projects, the UDF will need to conduct a more detailed review with the aim to select a target list of Urban Projects to which time and resources will be directed in order to conclude Investment Agreements.

This review typically builds on the initial assessment outlined in Section 2.2.1 above, with more detailed assessment work aimed at finalising a list of Urban Projects where a high degree of certainty exists around the capacity of Urban Project-implementing bodies to follow through on the investments. A deliverable Business Plan should be developed (if an appropriate one does not exist already) and a robust financial modelling and risk analysis can be concluded. These activities are key elements of the Investment Agreement through which the UDF will contract to invest in an Urban Project.

2.2.2.1 Finalising the list of target Urban Projects

In finalising the list of target Urban Projects, the UDF will need to consider all of the Urban Projects identified in the call for Urban Projects and utilise a suitable evaluation criteria to select those that are mostly likely to allow the UDF to efficiently and effectively meet its Investment Strategy.

At this stage, it is helpful to consider the key factors in the Investment Strategy of the UDF, which will have been set and how they manifest in focusing on Urban Project selection:

- An Urban Project must generate revenue or asset value enhancement that can repay investors *(financial viability)* – as a UDF Fund Manager will be placing Loan, Equity or Guarantees into a Urban Project, the information about the Urban Project from the initial call must demonstrate a reasonable probability of these repayments materialising.

- The Urban Project is eligible to be supported by the OP resources *(strategic fit)* – a UDF Fund Manager must be able to draw satisfactory conclusions about the amount of eligible expenditure within the Urban Project and the amount of UDF resources likely to be requested in order to gauge whether or not the eligibility requirements of the local OP can be met. (It is important to note here, however, that an Urban Project whose completion requires ineligible expenditure can receive JESSICA funding as long as the funding is provided only to the eligible portions of expenditure for the Urban Project).

- An Urban Project must be delivered in a reasonable timescale so as not to leave the UDF with uninvested resources for an extended period of time *(deliverability).*UDFs typically have to apply investment resources within the timeframes outlined in the OP (in the case of the 2007/13 OP, this is by 31st December 2015).

In addition, all Urban Project investments must be assessed as to whether or not State Aid is being provided and, where necessary, comply with the guidelines and principles of any general exemption or specific notification – which is outlined in Chapter 1.5 (State Aid).

It is important the UDF Fund Manager considers the following when finalising the Urban Project selection:

Financial Viability

The financial strength of the Urban Projects, and the ability to provide a commercial return, is assessed by reference to the Urban Project Internal Rate of Return (IRR) (i.e. before taking into account the funding structure) in the development phase. In addition, the timing of return is also relevant (for instance a quicker return on investment from the Urban Project will enable the UDF Fund Manager to reinvest resources in subsequent Urban Projects). It is also possible that a review of the JESSICA instrument needs to be undertaken against the results of funding the Urban Project using Article 55 rules and grant, or a combination of these.

Deliverability (Readiness for Urban Project Investment)

This stage assesses the readiness of Urban Projects for investment within time parameters (e.g. investment prior to potential date of decommitment of ERDF resources). UDFs have the option to place significant weight on this portion of the review if risk of decommitment is a key concern. This can also be set up as a pass/fail criterion. Factors included in this assessment will include the status of an Urban Project's planning permissions[27], as well as other deliverability issues.

Strategic Fit

This stage of the evaluation compares Urban Project fit with the fund's core objectives (as set out in the OP and the Expression of Interest Documentation) and alignment with an IPSUD. The reputation of the Urban Project sponsor will also be reviewed during this stage.

State Aid Compliance

Section 1.5 of the handbook outlines the State Aid issues facing a UDF when assessing its operations and investments into Urban Projects, including the approach that a UDF can take to providing its operations without aid or providing operations with aid, which can be done within the current rules or through a notification from the Commission of that UDF's operation.

In addition to the above and in specific relation to finalising a target list of Urban Projects when State Aid is provided, the UDF must consider:

- Proportionality – aid must be provided at the minimum level for investors at Urban Project and UDF level. Specifically, the UDF must not invest at a loss or invest at a level that provides higher than market rate returns for other investors. The Urban Project investment terms agreed by the UDF must also include a profit / loss sharing mechanism to maintain the principle of proportionality for variations in outturn of the Urban Project.

- Amounts of private sector lever – a UDF cannot finance an Urban Project without some sharing of investment risk with the other investors. This level of co-investment must be significant (generally not less than 30% of the Urban Project investment)[28] and adopt the principles of proportionality outlined above.

Examples of how UDFs (specifically in the North West of the UK and Andalucía) have obtained State Aid approvals for its proposed operations are included in chapter 1.5.3.

2.2.2.2 Structuring Investment Agreements between the UDF and Urban Projects

The next stage for the UDF Fund Manager to undertake after selecting targeted investment Urban Projects is to engage in a process of detailed due diligence to negotiate and agree an Investment Agreement with each Urban Project.

[27] The terminology used to describe the consent of an applicable statutory or judiciary bodies to proceed with building activity varies by country. "Development permits" or "construction permits" are also frequently used terms.

[28] See section 4.2.4 of the Community guidelines on State Aid to promote risk capital investments in small and medium sized enterprises.

Due Diligence Commentary

Due Diligence activities employed by UDFs is likely to vary depending on the nature of Urban Projects a UDF Fund Managers will be investing in. If the UDF is likely to invest small amounts in a high number of Urban Projects that are similar (a good example being the retro fit of housing accommodation undertaken by UDFs in Estonia), it is likely to utilise standard application processes and request for information. Whereas other UDFs investing large amounts in small number of project may take a different approach (UDFs in the UK that focus on large development projects accept approaches for funding from project promoters in a range of formats that have not been prescribed by the UDF Fund Manager).

However, it is important that the UDF Fund Manager follows the principles of 'sound financial management'[29] when considering Urban Project investment opportunities. As part of this process it is expected that the Fund Manager will review:

- Urban Project costs to ensure sufficient eligible expenditure is present;

- The financial projections to gauge the likelihood and risks to income and capital receipts.

Structure of the Investment Agreement

The Investment Agreement will be the contractual agreement between the UDF and the Urban Project for the provision of UDF investment resources. As such, it is a crucial document in protecting the proper use of OP resources and the long term sustainability of the UDF. The UDF Fund Manager will have been procured primarily on the basis of their ability to appropriately negotiate and structure this agreement, taking account of required regulations.

As a minimum requirement, the Investment Agreement should cover:

- Requirement to comply with OP obligations, in particular commitment to use OP resources from UDF for eligible expenditures;

- Term sheets for the proposed investment instrument – schedule of drawdowns, return rates, timing of repayments;

- Reporting and monitoring obligations;

- Security / charges over the Urban Project.

2.2.3 Approvals to sign Investment Agreements

As noted in the above Section 2.1.3 on UDF governance rules, UDFs will need to develop validation procedures for the selection and evaluation of Urban Projects, as well as the process of entering into Investment Agreements.

Typically, most UDFs will be governed by an Investment Committee that contains representatives of the HF/MA, plus other independent board members (as covered in Section

[29] The principles of sound financial management are referred to in Article 60 of the General Regulation and paragraph 2.6.11 of the COCOF 3 Note.

2.1.3). In approving the UDF Fund Manager to contract the UDF to provide resources, the Investment Committee should meet to consider the proposed investments, challenge (where necessary) the conclusions of the UDF Fund Manager, and approve (or decline / reject) the proposed investments.

The Investment Committee plays a key role in the governance process around Investment Agreements, and will typically assume an independent and objective role in reviewing proposed UDF investments. The remit and power of the Investment Committee should strike a balance between recognising the relative autonomy and independence of the UDF Fund Manager in selecting Urban Projects for investment, and reflecting the political and policy objectives of the MA.

The Investment Committee may also be capable of delaying an approval (for instance where further information is required) or providing approval subject to further conditions to be met (by the UDF Fund Manager or the Urban Project).

In preparing for these board meetings it is recommended, as a minimum, that the Investment Committee is provided with the following information on each Urban Project (preferably well in advance of the meeting):

- Summary of the Urban Project, including a description of its actions, location and proposed objectives;
- Evidence of the Urban Project's compliance with OP requirements;
- Evidence of the Urban Project meeting necessary local, national and EU regulations;
- Evidence of the Urban Project's compliance with the UDF Investment Strategy;
- Summary financial information about the Urban Project and the UDF's investment resources proposed.

3. INVESTMENT PROCESSES

This chapter of the UDF Handbook focuses on the operational process of releasing UDF investment resources into Urban Projects, capturing Income Receipts and Capital Receipts and holding cash reserves. The chapter assumes that the UDF Fund Manager will have already completed extensive due diligence into a particular Urban Project (as outlined in Section 2.2 of this handbook on Urban Project Investment Decision Making by UDFs) and decided that this Urban Project is suitable to be a Final Recipient for investment from the UDF.

This chapter focuses on actions required to manage investment resources that are under UDF Fund Manager's control, and thus sets out a best practice framework for UDFs. There are four primary actions that UDF Fund Managers must perform when managing the investment process of a UDF:

- 'Treasury Management' – holding investment resources within the UDF ready to be invested into an Urban Project that is selected to be a suitable investment by the UDF Manager;
- 'Disbursement' – including the process of checks to be undertaken prior to releasing investment resources from the UDF and into an Urban Project;
- 'Repayment' – in which the UDF receives repayment of initial principal plus any returns from the Urban Project at the correct and appropriate time;
- 'Investment Recycling' – including consideration of the options open to a UDF for the reinvestment of resources in later Urban Project rounds and the implications for the selection and timescale of these later investments.

The HF Handbook (Section 3.2) provides details on this investment process from the perspective of the Holding Fund.

The end of the chapter reviews the processes for closure of the UDF at the end of its determined lifespan, including how ERDF resources and other investments within the UDF are treated and their legacy.

3.1 Treasury Management

A UDF will normally be responsible for holding uninvested cash for a period of time before it is invested in an Urban Project or returned to the UDF as Repayment. These uninvested resources, referred to here as Idle Resources , relate to the following sources:

- OP resources;
- Co-Investment resources (provided by other investors into a UDF);
- Gains;
- Income Receipts and Capital Receipts.

The regulation draws a distinction between OP resources that are held by the UDF prior to a first round of investment in Urban Projects and resources held for subsequent investments. Resources held for the first investment round must be employed in line with the eligibility requirements of the OP they were drawn from (or more specifically, the Priority Axis or Priority Axes) and in doing so must be included within the statement of expenditure for that OP as defined by Article 78 of the General Regulation.

Section 5.2.1 of COCOF Note 3 clarifies Article 78 of the General Regulation on the treatment of resources returned to a UDF from investments, *"resources returned to the operation from investments undertaken by funds as defined in Article 44 or left over after all guarantees have been honoured shall be reused by the competent authorities of the Member States concerned for the benefit of urban development projects, of small and medium-sized enterprises or for energy efficiency and use of renewable energy in buildings, including in existing housing"*, which therefore allows a wider range of opportunities for the UDF to consider than that allowed for first round investments, which is restricted by the provisions of the applicable OP.

It will be the responsibility of the UDF Fund Manager to ensure that the investment resources are appropriately held in accordance with the best interests of the UDFs Investment Strategy. These Idle Resources are likely to materialise:

- On set up of a JESSICA Operation where a HF does not exist and the MA approves the payment of OP resources into a UDF (*"first round investment resources") and are not yet invested in Urban Projects*;

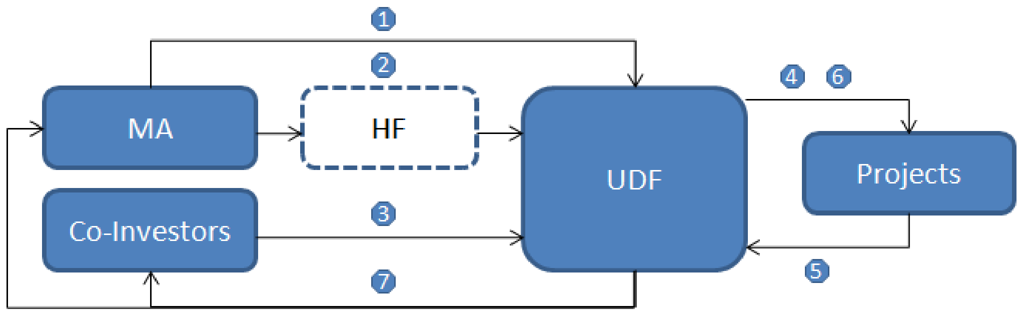
- When a HF exists and makes arrangements for the UDF to receive tranches of OP resources for a suite of upcoming Urban Project investments (*"first round investment resources")*;

- When an Urban Project repays UDFs investment resources to the UDF and these Income Receipts and Capital Receipts are not required to be passed back to a HF or other investor. The UDF would hold these returned resources while waiting to make other Urban Project investments;

- As part of its winding down process, the UDF will be exiting its Urban Project investments and generating a cash balance before returning it to investors.

The process diagram below outlines a typical flow of events for UDF Resources:

Flow of UDF Resources



1. Where an HF does not exist, MA approves and transfers payment of ERDF OP Resources into a UDF
2. Where an HF exists, HF makes arrangements for tranched ERDF OP payments into a UDF
3. Co-investors transfer funds to the UDF based on individual agreements
4. UDF invests in projects
5. Projects return receipts (income and capital payments) to UDF
6. UDF continues to re-invest resources into projects, OR
7. UDF returns receipts to investors.

Article 46 of the Implementing Regulation sets out the requirements for a UDF when investing resources into Urban Projects within an IPSUD, but does not address the issue of whether or not a UDF should place Idle Resources on deposit (or similar investment tool). Therefore, it is recommended that UDFs should comply with the Commission's principles of 'sound financial management'[30] and make appropriate arrangements for Idle Resources to generate a return for the benefit of the UDF, which may include covering operating costs or increasing the overall investment resources available to the UDF. Best practice of UDFs established so far reflect the following:

- Hold cash resources with a reputable bank to minimise risk of loss of deposits;
- Ensure resources can be accessed in a reasonable amount of time to reflect Urban Project investment needs and are not locked into long term deposits that restrict flexibility.

Any Gains received on Idle Resources must also be treated in accordance with the regulations and COCOF Note 3.

It is important to note that Gains earned on unspent OP resources provided to the UDF by a MA or HF being held for first round investment effectively become additional OP resources (as referenced in COCOF Note 3). These Gains effectively adopt the same restrictions and obligations as the OP resources from which they were generated and must be deployed by the UDF as if they were, effectively, OP resources.

Good Treasury Management practice from the investment fund industry also includes placing cash resources in separate bank accounts relating to how it was generated and its future intended use. Not only does it facilitate good record keeping for monitoring and audit purposes (which is covered in Section 4 of this handbook) it also ensures that Gains generated on deposited resources is directly attributable to the sources from which they arose. Several UDFs have adopted a 'two account' structure for this purpose, described as follows:

[30] Article 60 of the General Regulation

- Disbursement Account – to hold initial payment of OP resources that the UDF receives from the MA or HF;

- Reserve account – to hold Income Receipts and Capital Receipts received from Urban Projects in the form of repayments of investments and investment profits.

Each account is expected to be with a reputable bank and bearing interest that is commensurate with the prevailing market rates. These conditions are expected to be organised by the UDF Fund Manager. It is also possible that a HF or MA may require a legal charge over one or both of the accounts to provide any necessary security relating to the Level II Funding Agreement.

3.2 Disbursement

UDFs are required under the regulations to ensure that OP resources are used only to finance eligible expenditures in Urban Projects. In this document the simplified terminology 'eligible Urban Projects' is used to denote eligible expenditure in projects satisfying the criteria spelled out in the OP and required by the regulatory framework governing the use of financial instruments for urban development. The disbursement of resources from the UDF to the Final Recipient namely to the eligible Urban Project is the key event to satisfy the final certification of the payment and avoid decommitment (claw-back)[31].

The initial selection and subsequent due diligence performed by the Fund Manager to select eligible Urban Projects, detailed in Section 2.2, will have resulted in an investment pipeline, which in turn will inform the UDF Fund Managers' plans to draw down sufficient resources from the MA or HF (and possibly other investors) ready to invest into Urban Projects. Furthermore, each Urban Project will have signed an Investment Agreement with the UDF that details how investment resources move from the UDF into an Urban Project, helping define the quantum of investment resources that must be available to the UDF at any one point in time. (The process of setting up an Investment Agreement and an overview of an example structure are included in Section 2.1.2).

At the point an Urban Project requests disbursement of the investment resources, a final check of Urban Project compliance should be undertaken by the UDF to ensure the Urban Project investment remains as agreed in the Investment Agreement. Good practice is for the UDF Fund Manager to request information from the Urban Project receiving the UDF investment covering the following:

- Overview of the Urban Project status and confirmation of the outputs and objectives to be delivered;

- Where a series of investments are being made into an Urban Project, confirmation that past investments are proceeding according to expectations;

[31] For further guidance on the requirements at closure of the OPs please see Commission Decision C(2013)1573 which includes specific references to Financial Engineering Instrument.
http://ec.europa.eu/regional_policy/sources/docoffic/official/guidelines/closure_2007_2013/guidelines_closure_20072013_en.pdf

- Amount of resources required from the UDF and confirmation of the terms and conditions under which the resources are to be provided;

- Where necessary, that the requirements for any National Co-financing provided at project level have been met (covered in Section 1.1.3);

- Confirmation that all required approvals have been received from the MA.

The UDF Fund Manager is responsible for assessing the information received back from the Urban Project at this time and concluding whether or not the Urban Project investment remains valid, based on the requirements of the applicable OP and the terms of its Operating Agreement with the HF/MA. There are examples of Operational Agreement terms that require the UDF Fund Manager to obtain approvals from MA or HF in order to release the disbursement.

Most Operational Agreements include a reporting obligation, either at the point of investment resources being disbursed into an Urban Project or at a reporting period end (say monthly or quarterly), that resources have moved from the UDF into an Urban Project. Section 4.3 of this handbook covers reporting requirements in further detail, but typically for this event, the following information is included in the report:

- Description of the Urban Project and the funding being provided by the UDF;

- Compliance with Investment Agreement terms;

- Confirmations / certifications of compliance with all relevant obligations and regulations.

Section 4.2 of this document includes two examples of reporting templates within which this detail may be outlined regularly for reporting purposes.

3.2.1 Disbursing an investment in tranches

The UDF Fund Manager should adopt principles of good financial management[32] when releasing resources to an Urban Project. The timescale for the delivery of some Urban Projects may be over a number of years and the UDF Fund Manager must be aware of when the Urban Project will actually defray its received investments on eligible expenditure. In doing so, the UDF Fund Manager should obtain a reasonable balance between the number of times an Urban Project requires resources to be disbursed and the amounts of unspent resources that are held by an Urban Project implementing body. Where necessary, the disbursement of investment may be associated to contractual obligations for the Final Recipient to spend OP resources on eligible uses (expenditures).

In determining this balance, the UDF Fund Manager must be conscious of project risks leading to UDF disbursed resources that could otherwise be utilised on other investments being tied up, but not spent, within an Urban Project.

Typical Urban Project risks that should be considered by the UDF Fund Manager include:

[32] As referred to in Paragraph 2.6.11 of COCOF Note 3 and Article 60 of the General Regulation

- **Local External Dependencies** – where the timely completion of an Urban Project depends upon local external circumstances, such as infrastructure development like car parking, roads or other transport links);

- **Local Internal Dependencies** – where the timely completion depends on the progress of other components of the UDF portfolio, for example, UDF-funded Urban Project *X* may be dependent upon the completion of UDF-funded Urban Project *Y*;

- **Local delivery capability** – does the delivery partner continue to have the capacity to implement the Urban Project as per the agreed timelines? Are there any new or changed delivery risks at this stage? Will suppliers continue to be able to provide the necessary resources and services? Has any unexpected issue arisen in the development of the Urban Project?

- **Relevance** – is the Urban Project still relevant to the strategic aims of the UDF? For example, the Urban Project may have evolved during its development. Is it still delivering outputs in line with the objectives of the Urban Development Plan?

These risks should be considered at each disbursement, to ensure that payments are dispensed responsibility and fruitfully.

3.2.2 Assuming security on disbursements

Good practice by the UDF Fund Manager, as part of undertaking due diligence on an Urban Project, would be to identify where the UDF can take security from the Urban Project or Urban Project delivery partners, to ensure recovery of its invested resources should difficulties arise with an Urban Project causing a default on its scheduled Income Receipts and Capital Receipts.

Obtaining security for an investment is not an explicit regulatory requirement for HFs or UDFs, but may be required as part of the Level II Funding Agreement between the UDF and the HF/MA which includes setting up the Investment Strategy and contractual agreements to establish the UDF. It is possible that to further the socio-economic objectives of the UDF, the HF/MA may allow the UDF to make unsecured investments into Urban Projects. This is part of the UDF Investment Strategy, which is developed to suit the design of each UDF and has been covered in further detail in Section 1.3.

Particularly in the absence of a dispensation from the HF/MA for certain investment circumstances, a UDF should make sure to seek some form of investment security to protect the UDF resources. Typical types of investment security associated with Urban Projects include:

- Legal charge over an asset or series of assets that the UDF can invoke in the event of a default;

- Guarantee from one or more of the Urban Project Delivery Partners for the investment (potentially the initial principal capital and profits, especially with regard to Loan interest) which the UDF can call on in the event of default;

- Similar Guarantee from a third party with a vested interest in the Urban Project proceeding (typically local public sector organisations).

The Investment Agreement should include details of security provisions and the appropriate process to call in security if and when required. The UDF should also ensure that security is in place and evidenced at the time a disbursement is requested by the Urban Project.

3.2.3 Monitoring Investment Progress

The next chapter covers post-investment processes (including monitoring tasks) which a UDF should undertake whilst its resources are invested in an Urban Project. The purpose of this monitoring is to ensure that the UDF is fully aware of the progress of an Urban Project and is able to take action to protect its investment if an issue should arise with the delivery or implementation of an Urban Project – for example, withhold further investment resources, call in security or reassess the Urban Project's eligibility to receive OP resources.

The monitoring process for invested resources is usually designed by the UDF Fund Manager to best suit the particular nature of its investment portfolio and reporting obligations under the Level II Funding Agreement. Key principles would include regular reporting on the status and progress of an Urban Project, which fits with previously agreed implementation plans, including:

- Suitable certification of the Urban Project's progress by a credible, independent third party;
- Confirmation that no litigation issues have arisen with the Urban Project's previous activities;
- Confirmation that no material changes have rendered the Urban Project ineligible for using ERDF resources;
- All required security / charges remain in place in favour of the UDF;
- Any other issue that could potentially cause concern for the UDF Fund Manager.

3.2.4 Changes to the investment requirements

At the time of requesting a disbursement, an Urban Project may indicate or the UDF may discover through monitoring that a change has taken place in the investment requirements or the Urban Project is not proceeding as expected. In these cases, the UDF Fund Manager has a number of obligations to fulfil, which include:

- Reviewing the Urban Project changes to establish if the Urban Project remains eligible to receive an investment;
- Ensuring that the revised Urban Project represents value for money (as defined by the UDFs Investment Strategy);
- That no breaches of the OP or EU rules have taken place (refer to Chapter 4, section on irregularities).

3.3 Repayment

The repayment of resources is covered in two stages in this handbook:

- Firstly, the Income Receipts and Capital Receipts from investments that have been made by the UDF into Urban Projects;

- Secondly, the repayment of OP resources by the UDF to the HF/MA.

Often contracts made by the MA to award an Urban Project a grant include a provision for recovering some of the grant, if the Urban Project demonstrates through its delivery that a smaller amount of grant would be sufficient. This principle of utilising OP resources as a funder of last resort ensures that only the minimum resources are used from an OP to deliver targeted economic outputs. Typically, this is the case for revenue generating projects under Art. 55 of the General Regulation, which however does not apply to Financial Engineering Instrument.

JESSICA Operations in most cases invest OP resources on the expectation that full repayment will take place. The simultaneous use of grants and Financial Engineering Instrument to support the same Final Recipient is allowed in accordance with Article 43(6) of the Implementing Regulation. However, the two streams of funding should be considered as falling “under separate operations” according to point 3.1.2 of COCOF Note 3, so that separate accounts and records for each stream of finance are maintained. The detailed procedures to support such a combination are therefore complex and very limited practical experience, if any exists in this realm.

3.3.1 Income Receipts and Capital Receipts from investments in Urban Projects

Urban Projects should be required, where there are sufficient returns available, to provide Income and Capital Receipts to the UDF in line with the Investment Agreement. The approach to Investment Agreements is set out in Section 2.2.2 of this handbook and includes guidance on how Income Receipts and Capital Receipts should be calculated based on the three main investment instruments a UDF can utilise, namely Loan, Equity or Guarantees.

The timing and calculation of Income Receipts and Capital Receipts must be formalised in the Investment Agreement negotiated between the UDF and the Urban Project when UDF resources are committed to an urban project. It is likely to include:

- Criteria for the calculation of the Income Receipts and Capital Receipts, such as:
    - Loans – normally an interest rate applied to outstanding Loan amounts;
    - Equity – normally a share of profits reflecting the status of the UDF’s Equity Investment alongside the other Equity investors;
    - Guarantees – a premium payable to reflect the level of Guarantee provided;

- Timing of Income Receipts and Capital Receipts, normally reflecting agreed periods or trigger points at which the above calculation of Income Receipts and Capital Receipts is undertaken and suitable payment made to the UDF.

The UDF Fund Manager should ensure that the above is included within the monitoring activities they are undertaking on all Urban Project investments to ensure that the volume and timing of Income Receipts and Capital Receipts are in line with expectations (further details on monitoring are outlined in Section 4.1).

The Investment Agreement must also specify how the Urban Project should pay Income Receipts and Capital Receipts to the UDF. Typically, this will be paid into an account separate from the one used by the UDF to provide resources to the Urban Project, as outlined earlier in the 'Treasury Management' section of this chapter.

3.3.2 Order of settlement from Urban Project Income Receipts and Capital Receipts and UDF fees

In line with the principles of sound financial management, it is suggested that UDF Fund Managers apply Income Receipts and Capital Receipts received from Urban Projects in the following order of settlement:

- Gains calculated in accordance with the Investment Agreement terms;
- Other outstanding Income Receipts and Capital Receipts as set out in the Investment Agreement.

In addition to the above, the Level II Funding Agreement between the UDF and HF/MA may also allow the collection of a fee by the UDF at the point in time when an Urban Project makes a return. (Section 5 of this handbook details the types of fees which UDFs can charge either an Urban Project or the HF/MA for its services and investments).

UDF Fund Managers must comply with Section 2.6.15 to 2.6.17 of COCOF Note 3 when charging Urban Projects arrangement fees (or other similar fees associated with the provision of investment resources). Section 2.6.15 states that if arrangement fees are charged to a Final Recipient (in this instance, the Urban Project), then to ensure no duplication on the OP statement of expenditure, the fund manager must deduct the charged amount from its declaration of expenditure. Section 2.6.17 notes that at the closure of the programme, the total amount charged by the UDF to Urban Projects for such arrangement or other fees must be deducted from the management costs or fees declared as eligible expenditure for reimbursement from the Structural Funds.

It is difficult to provide detailed guidance on the timing of settlement for UDF Fund Manager fees as they potentially are dependent on a number of factors, such as risk assumed by the UDF, conditions of the Level II Funding Agreement or Urban Project specific factors. Good practice by UDFs and MAs/HFs is to provide clear schedules, in conjunction with the above order of settlement, regarding the fees that the UDF can charge, the events which allow those fees to be charged, and the resources from which they can be drawn.

3.3.3 Events of Urban Project default

Throughout the lifetime of an Urban Project, issues may arise with its implementation that prevents it from making a required return. For example, a reduction in Urban Project profitability, unexpected costs or cash flow restrictions. These are commonly referred to as 'events of default' and describe any instance where an Urban Project cannot make its contractually due return to the UDF.

Should such an event arise, the UDF Fund Manager is responsible for protecting the UDF investment resources and should identify the cause and implications of the default, and propose a suitable remedy, normally in conjunction with the Urban Project representatives. This could include:

- Reassessing if the Urban Project is still eligible to receive all of the initially foreseen UDF's investment resources, which include OP resources, and if necessary adjusting the Investment Agreement to reflect a reduced investment commitment by the UDF;

- Negotiating revised terms for the investment resources, such as an extended period for Income Receipts and Capital Receipts to be made or a reduction in the level of expected Income Receipts and Capital Receipts (in compliance with applicable regulations, including State Aid);

- Initiating procedures to call in any security or Guarantees that have been provided by the Urban Project for the UDF's investment.

3.3.4 Process for writing off irrecoverable investment resources

In the event of a major default by an Urban Project, where a substantial loss of Income Receipts and Capital Receipts is expected, the UDF Fund Manager must demonstrate to the satisfaction of the HF or MA that the expected return can no longer be reasonably expected. It is recommended that the UDF and HF/MA agree a protocol for recording and agreeing such events.

3.3.5 Repayment of returned resources to the HF/MA

The HF Handbook (Section 3.2.2) describes arrangements through which repayments are expected to take place between a UDF and HF/MA:

- Level I Funding Agreement repayments – funding repaid from the UDF to the HF, or, in the case where no HF exists, from the UDF to the MA;

- Level II Funding Agreement repayments – funding repaid from the HF to the MA.

COCOF Note 3 expressly states that it is up to the parties engaged in a Level I Funding Agreement or Level II Funding Agreement to:

> *"...determine the exact time when resources, which are attributable to the Structural Funds contribution, returned to funds can be returned to the competent authority to be re-used for urban development projects... It would be reasonably expected that this would happen between the end of the investment period and the winding up of the fund"*.

The timing and scale of repayments to be made by UDFs must therefore be described in Level II Funding Agreements.

Typically the repayment provisions of the agreement will consider the following:

- The requirement of the HF/MA for the UDF to undertake further rounds of investment in Urban Projects;

- The HF/MA's policy on re-appointing of UDFs;

- The HF/MA policy on the treatment of Idle Resources to be held by a UDF, especially on the length of time UDFs can hold such resources;

- The duration of the Level II Funding Agreement, especially the ability of the UDF to complete further investment cycles within the envisaged term of the agreement.

3.4 Investment Recycling –Follow-on Investments

Article 43(3) of the Implementing Regulation requires Structural Fund operations delivered through HF and UDFs to describe in the Level I Funding Agreements and Level II Funding Agreements provisions for the reutilisation of Income Receipts and Capital Receipts. In addition:

- Income Receipts and Capital Receipts from UDF investments, or resources left over after all Guarantees have been honoured, are required to be reused in a manner consistent with the requirements of Article 78(7) of the General Regulation, namely that the resources returned should be re-used by the competent authorities of the Member States concerned for the benefit of Urban Development Projects, of small and medium-sized enterprises or for energy efficiency and use of renewable energy in buildings, including in existing housing;

- First Round Investments made involving OP resources must comply with the State Aid rules. While Follow-on Investments are not subject to the rules on the use of OP resources for First Round Investments, they are still regarded as State resources and therefore should be used in compliance with State Aid rules as provided for under Article 54 (4) of the General Regulation;

- COCOF Note 3 recommends that *"resources returned from investments attributable to the Structural Funds contribution to Financial Engineering Instrument shall be re-used in the region(s) covered by the Operational Programme and that re-use should be through Financial Engineering Instrument, with a view to ensuring further multiplier and recycling of public money"*.

In aligning JESSICA Operations with IPSUDs and by virtue of possible further rounds of investment, the investment funds established through JESSICA Operations are strategically-focused long-term investment vehicles that almost certainly will continue to exist beyond the OP implementation period ending in 2015. While OP resources should be deployed by the UDF before end-2015 at the latest, UDFs (and candidate UDFs) are nevertheless well-positioned to attract other investors into the fund to increase investment resources in the long term.

An important benefit afforded to UDFs within both the General Regulation and the Implementing Regulation, is the lessening of investment restrictions after First Round Investments. In other words:

- First Round Investments must be invested in Urban Projects that are compliant with Structural Funds regulations, ensuring that the Urban Project forms part of an IPSUD and has a sufficient level of Eligible Expenditure to justify the OP resources invested in the Urban Project;

- Follow-on Investments are required only to be re-used by the relevant MS for the benefit of urban development projects, of small and medium-sized enterprises or for energy efficiency and use of renewable energy in buildings, including in existing housing. There would appear to be no explicit reference in the EU regulations for Follow-on Investments to fully comply with Structural Funds regulations, including alignment with OP Priority Axes, the IPSUD requirement and other components enabling Eligible Expenditure.

Depending on the agreement made with co-investment partners, whether public or private, and the special arrangements that may have been integrated into the UDF Investment Strategy for the benefit of the co-investment partners, a UDF may pay Income Receipts and Capital Receipts directly to the co-investment partners or further re-use the resources for Follow-on Investments. (Please also see section 3.5.1 on Normal exit procedures).

3.4.1 Reinvestment decision making processes

Upon appointment, the UDF Fund Manager will have provided a Plan which will have been developed further if necessary and integrated into the UDF Investment Strategy. The HF/MA will monitor the implementation of the UDF Investment Strategy and, where foreseen, approve milestones identified within it during implementation. One such expected approval will take place at the stage of entering into Follow-on Investments, if envisaged. Here the HF/MA should ensure that the UDF Investment Strategy fits with HF/MA's policy for Follow-on Investments as should be described in the HF/MA Investment Strategy.

In turn, the UDF will be responsible for evidencing that the above requirements are met and that all resources used for Follow-on Investments are either:

- resources returned from First Round Investments; or
- newly identified Co-Investment resources.

3.4.2 Withdrawing returned resources

The MA or HF, depending on the funding and Level II Funding Agreements in force, may choose to withdraw resources from the UDF at the point of resources being returned to the UDF following First Round Investments or following subsequent Follow-on Investments, leaving the UDF to operate with other remaining resources. In this context, Section 9.2.4 of COCOF Note 3 states that "*while it is recommended that resources returned should be used until exhaustion of the funds for the same type of action(s) and in the same fashion, after the closure of the programming period there is no specific legal obligation to use the residual funds in the context of interventions of the Structural Funds".*

3.5 Exit Strategy

Article 43 (3) (c) and (d) of the Implementing Regulation outlines elements of the Exit Strategy that should be included in the Level II Funding Agreement. In effect, a UDF will have two major Exit Strategy procedures:

- Firstly, the exit of UDF resources from Urban Projects, as outlined earlier in this chapter; and
- Secondly, repayment of resources back to a HF/MA and the termination of the associated Level II Funding Agreement.

Typically a UDF Fund Manager will have been appointed for a fixed period to manage OP resources on behalf of the MA. The terms of the appointment will of course take into account the Level I Funding Agreement, where the UDFs are organised through a HF.

A UDF will usually exit from its investment in a Final Recipient upon completion of the Urban Project and satisfactory payment of Income Receipts and Capital Receipts as described by the Investment Agreement with the Urban Project and outlined by the Exit Strategy described within the Level II Funding Agreement. Early withdrawal of resources from an Urban Project should also be allowed for, however, for example in the event of default by an Urban Project. The later may include accepting lower than expected Income Receipts and Capital Receipts from the Final Recipient and writing off investment resources.

The Exit Strategy defined by the Level II Funding Agreement must also take account of section 5.2 of COCOF Note 3 “Resources returned to operations from investments undertaken by funds” and section 9.2 “Legacy resources”. As outlined earlier in this document, the lifetime of the UDF as set up in a Level II Funding Agreement may include one or more rounds of investment. The MA’s requirements for the closure of the UDF and return of resources must therefore account for the nature of investments likely to be made, their timescale for making Income Receipts and Capital Receipts and any future commitments falling due on the UDF. (For further guidance on the requirements at closure of the OPs please see Commission Decision C(2013)1573 which includes specific references to Financial Engineering Instrument[33]).

3.5.1 Normal exit procedures

On the assumption that the UDF invests its resources successfully into Urban Projects and receives expected Income Receipts and Capital Receipts over the duration of its appointment, it will reach a point whereby it must return all OP resources to the HF or MA as required by Article 43 of the Implementing Regulation. It is important to note that this does not mean all the available investment resources of the UDF (e.g. including Co-Investment resources), so the Exit Strategy provisions must clearly articulate the process for resource treatment during the wind up of the UDF.

In addition, the legacy of the UDF must be considered at the exit phase, not least because the withdrawal of the OP resources could reduce the total investment resources of the UDF to a level that it cannot meet investment demands of further waves of urban projects, or not be economically viable at the reduced size.

It is therefore important to consider the possible scenarios that could arise through the selection of an Exit Strategy:

Reappointment scenario:	The MA or HF decides to reinvest all or part resources back into the UDF and enter into a further Level II Funding Agreement. The UDF continues to operate for a further period of investment activity under an Investment Strategy agreed with the HF/MA, plus other remaining co-

[33]http://ec.europa.eu/regional_policy/sources/docoffic/official/guidelines/closure_2007_2013/guidelines_closure_20072013_en.pdf

	investment providers.
OP MA exit scenario:	The UDF has to repay all OP resources to the HF/MA. The remaining investment resources (co-investment) continue to be under the control of the UDF Fund Manager and the UDF invests in projects based on an Investment Strategy agreed by the co-investors.
Co-investor exit scenario	The UDF has to repay all Co-Investor Resources to co-investors. The remaining OP resources of the MA / HF remain under control of the UDF Fund Manager and the UDF invests in Urban Projects based on rules governing Follow-on Investment regulations.
Closure scenario:	All investment resources are returned to investors and the UDF closes.

3.5.2 Method of repaying OP Resources

It is expected that during the normal repayment of resources back to either the HF or MA by the UDF the following actions will be undertaken:

- The UDF will inform the HF/MA in a reasonable period before any amounts are to be repaid, including the relevant analysis of the resources being repaid (i.e. attributable to the Structural Funds contribution, or co-investment resources);

- HF/MA to confirm the repayment is based on the UDF agreements as expected and to provide necessary banking details for the repayment.

There currently is little case study information to provide an illustration for the long term use of UDF resources beyond the OP timeframe. Most of the UDFs established at the time of writing have developed bespoke agreements between the Fund Manager and the MA HF on how the Fund Manager can utilise the UDF resources on an on-going basis.

3.5.3 ERDF legacy requirements

Once the exit policy and approach to winding up the UDF has been defined in the Level II Funding Agreement, complying with Article 43 (3) and Sections 5.2 and 9.2 of COCOF Note 3, the MA has to determine the use of any funds returned to it by the UDF. As already mentioned in section 3.4.2 above, after the closure of the programming period, there is no specific legal obligation to use such funds in strict compliance with Structural Funds regulations.

Section 9.2.3 of COCOF Note 3 however states that *"the Commission considers as a good practice that resources returned attributable to the Structural Funds as well as any contributions left over after honouring guarantees which are attributable to the Structural Funds should be reallocated for the same type of action(s) in line with Article 78(7) of the General Regulation and in the same region covered by the Operational Programme". In addition,* Article 90 of the General Regulation requires access to information and to fulfil some obligations even after the OP has come to an end. Most of these requirements relate to the monitoring, reporting and auditing processes associated with the ERDF OPs, but some could relate to the nature of second-round investments that a UDF may have made. (Sections 1.3.4 and 1.3.5 of this handbook outline the reinvestment requirements of the regulations effecting the UDF's reinvestment of ERDF resources in later projects. Section 4.3 of this handbook outlines the further requirements for UDF reporting).

3.5.4 Early exit due to default

Depending on the conditions of the UDFs Level II Funding Agreement with the HF/MA, the early withdrawal or writing off events, outlined above, may trigger exit provisions that affect the on-going operation of the UDF.

Similarly, actions of the UDF that are not compliant with provisions of the applicable Operating Agreement with the HF/MA could result in early exit. Such examples may include wilful fraudulent activities, not fulfilling reporting or auditing requirements, or failing to provide updates. Such activities would typically trigger procedures to handle irregularities, outlined in more detail in Section 4.

In such events, the following may occur:

- Prevention of the UDF charging any additional fees for services provided or collecting any performance fee attributable to it;

- Ending of the Level II Funding Agreement between the UDF and HF/MA and the UDF losing the entitlement and resources to invest in Urban Projects.

4. MONITORING, MANAGEMENT VERIFICATIONS, AUDITING AND REPORTING

Structural Funds are managed in partnership between the Commission and MS (a process referred to as 'shared management'). The main rationale for shared management is to allow MS to take the lead role in shaping how Structural Funds assistance is spent and managed through their OPs. MS are required to design a system of controls to oversee the implementation of OPs and undertake appropriate monitoring and auditing. The Commission performs a supervisory role over the MS's systems.

The rules for setting up the systems and controls for Structural Funds are defined partly by the Commission and partly by MS. They are designed to ensure value for money, proper management and consistency with Commission policy for the implementation of Structural Funds.

Activities involved in the oversight of a MS's OP fall under the following four areas:

- **Monitoring** involves the structured and periodic registration of financial and operational information about the progress of implementation of an OP and the supervision of the actors responsible for that implementation, which includes progress in making programme or Urban Project investments. The monitoring process should be designed so that all parties involved in the implementation of an OP can receive information on progress of parties below them in the 'hierarchy of implementation', take corrective action as required and provide information to those above them;

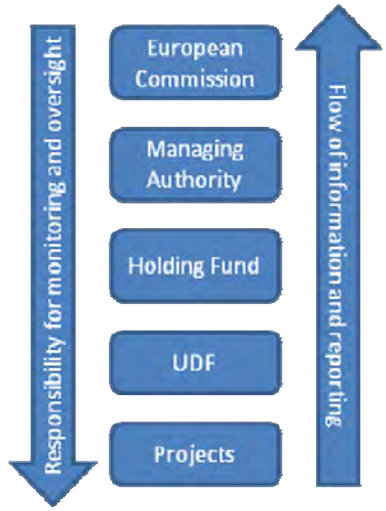
- **Management Verifications** are considered by the Commission to be the foundation of the Structural Funds control systems and are undertaken by the MAs. They consist of a comprehensive check on documents and reports, plus on-the-spot site visits, to verify where necessary a sample of the Urban Projects which are subject to monitoring. Verifications help the MA to establish confidence over the information provided through the monitoring process, the robustness of the control systems and make improvements when necessary;

- The objective of **audit activities** with regard to Financial Engineering Instrument for urban development is to obtain reasonable assurance that the management and control systems relating to the UDF are functioning effectively to prevent, detect and correct irregularities in a timely manner. In doing this, audit activities check the validity and reliability of financial information and assesses the soundness of internal controls within the UDF. Auditing is the responsibility of the Audit Authority of the MS and the Commission;

- **Reporting concerns** the development of documentation and evidence for data collected during monitoring and audit activities. Reporting processes reflect the Commission and MA's minimum requirements for the collection and retention of documents to provide an audit trail to evidence the appropriate implementation of the Structural Funds.

Within Financial Engineering Instrument for urban development, the responsibilities for the above activities are distributed across final recipients / Urban Projects, UDFs, HFs and MAs under the overall supervision of the Commission. Each actor within JESSICA Operations takes on separate roles, within a hierarchy of responsibilities, illustrated below, to ensure that the necessary control systems are monitored and maintained.

Illustration of the 'hierarchy of responsibilities' in the JESSICA Operation



The Commission sits at the top of this hierarchy and supervises the monitoring and audit activities of the MS, which is required to establish a number of other authorities, as defined in the applicable regulations, which become part of either the monitoring or auditing processes. The following is a short description of each authority, indicating the clear separation of their duties across the monitoring and auditing processes:

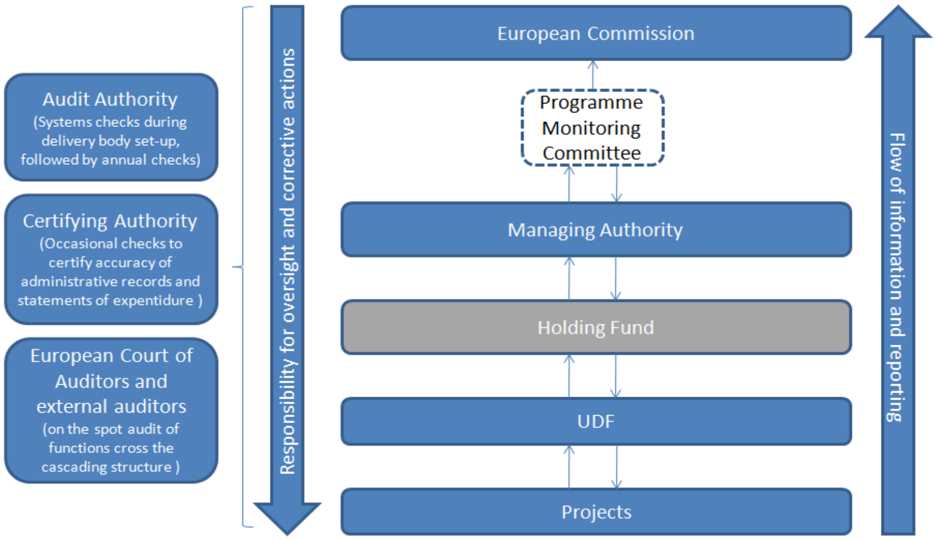
- **Certifying Authority (CA)** – responsible for certifying all expenditures and applications before they are sent to the Commission (Article 61 of the General Regulation);

- **Audit Authority (AA)** – independent of the MA and CA, responsible for checking the effective functioning of the management and control systems (Article 62 of the General Regulation);

- **Programme Monitoring Committee (PMC)** – ensures the quality and effectiveness of the programme for the use of Structural Funds. The PMC has oversight over the activities of the MA to ensure that operations, included those implemented through Financial Engineering Instrument for urban development, meet programme requirements (Article 63-65 of the General Regulation).

A Programme Secretariat role has also been defined by the Commission[34]. The Programme Secretariat is responsible for assisting the MA and PMC in the execution of their tasks and responsibilities. The Programme Secretariat can, if appropriate, undertake some of the verification work on behalf of the MA, plus act as a coordination point for monitoring and reporting information from Financial Intermediaries, final recipients and Beneficiaries prior to passing information to the MA.

[34] MA,CA,AA,PMC and Programme Secretariat definitions have been taken from *Managing Structural Funds: A Step-by-Step Practical Handbook, EIPA, 2008*



Control System for JESSICA Operations

As outlined above, the MA has the responsibility for making sure that operations delivered through JESSICA Financial Engineering Instrument are effective and correctly implemented. Alongside this, the Certifying Authority in the MS has the function of declaring that all claims for payment made by the MA to the Commission are compliant with applicable regulations. Setting up a suitable control environment for JESSICA Operations therefore falls under the responsibilities of the MA.

The MA, with the support of the HF where applicable, should establish a control system in a manner that is likely to be viewed as "works well" by the Commission auditors.

Section 3 of COCOF 08/0019/01-EN ("Guidance document on a common method for assessment of management and control systems in the Member States") sets out 15 key requirements and 50 assessment criteria for control systems, which are based on the legal requirements of the 2007/13 programming period.

Section 4 of the same guidance note, also provides a model for assessing the control systems and suggests four categories (from "works well" to "essentially does not work") to describe the control systems in place.

Section 3.3.1 of the HF Handbook describes the type of practical information a HF should make available for the purposes of monitoring and reporting, which could similarly be requested from the MA if a HF does not exist. As noted earlier in this section, the UDF normally operates under a contractual obligation, typically through a Level II Funding Agreement, to provide this information.

In addition, the UDF is required to cooperate with information requests and visits from the Certifying Authority and Audit Authority, plus any Management Verifications undertaken by the MA. These processes exist because the Commission requires each stakeholder to have a place within each OP management structure alongside the MA to certify the soundness of programme and Urban Project investments. In the case of JESSICA Operations, some of these bodies may sit outside the basic MA-HF-UDF structure and their involvement in monitoring, auditing and reporting activities is thus likely to vary across MS, and UDF managers will need to understand how this may influence monitoring and reporting obligations.

The majority of the oversight activities are conducted via control checks and site visits, as summarised here:

- **Systems Checks (by the Audit Authority)** – Include an initial check of control systems to certify operations during UDF set-up and an annual check to develop the Annual Control Report required by the Commission;

- **First Level Controls (by the Managing Authority)** – On-going / routine administrative checks of UDF activities, including Urban Project information, progress reports and payment claims (Management Verifications); includes site visits to Urban Projects to verify operations and systems.

- **Second Level Controls (by the Audit Authority)** – Annual audit visits to a subset of operations based on random statistical sampling to verify expenditure declared.

- **Follow-up Checks (by the Certifying Authority)** – Conducted as required following First and Second Level control checks to ensure the accuracy of administrative records and statements of expenditure; it may also include Urban Project site visits.

In addition, outside bodies such as the European Court of Auditors and other external auditors may periodically conduct control visits. Given these many activities, it will be important for UDFs to establish systems of monitoring and reporting jointly with HFs and MAs to ensure that systems are suitable for wider Commission requirements.

Reference should be made to Section 1.9 of this document, which contains details on the certification of ERDF Resources drawn into FEIs, and links to the appropriate regulations.

4.1 Monitoring

Monitoring is the structured and periodic registration of financial and physical information about an OP including Urban Project investing through Financial Engineering Instrument. The overall objective of monitoring is to scrutinize the effective transfer of OP resources through the UDF into Urban Projects and the progress in Urban Projects implementations against stated programme objectives.

Monitoring should not be confused with reporting requirements. The role of monitoring is essentially to check OP progress while reporting is linked to the collection of evidence for auditing.

Monitoring responsibility cascades down the JESSICA Operations structure (MA, HF, UDF and final recipients/ Urban Projects). Each layer of the hierarchy must ensure it monitors the layer immediately below, which should include receiving appropriate information flowing through underlying layers.

It is important to note at this stage that the MA has a responsibility to test the information through management verifications, with the level of testing reflecting its judgement on the effectiveness of the control systems in place.

An indicative list of the types of issues which UDF monitoring should be able to identify would include:

- Claiming for unspent expenditure
- Claiming for expenditure pre-start date
- Double funding
- Lost invoices / receipts
- Lack of evidence for staffing costs
- Material changes to the Urban Project
- Ineligible expenditure
- Ineligible beneficiaries
- Reconstituted records to cover poor initial recording
- Failure to follow funding or regulation requirements, including publicity guidelines
- Failure to evidence cash and in-kind contributions
- Failure to capture outputs and evidence them appropriately

UDFs will need to set up monitoring procedures able to identify such issues if they occur either within the UDF, but possibly also at Final Recipient / Urban Projects levels. The HF Handbook (Section 3.3.1) provides details on the way in which financial and non-financial information can be collected and provides examples of the checks on activity used for OP resources.

4.1.1 Monitoring Regulations

Every MA has the obligation to monitor the effectiveness of the implementation of its OP. A MA is allowed some flexibility on how monitoring is actually carried out, working with UDFs and where applicable HFs to define monitoring procedures for JESSICA Operations.

Annex II to COCOF Note 3 provides guidance on the reports to be made on the implementation of Financial Engineering Instrument:

1. By 31 January and by 15 September each year, the Managing Authority shall send to the Commission a specific report covering the operations consisting of Financial Engineering Instruments for the period until 31 December and until 30 June respectively.
2. The reports referred to in paragraph 1 shall include, for each Financial Engineering Instrument, the following information:
   (a) description of the Financial Engineering Instrument and implementation arrangements;
   (b) identification of the entities which implement the Financial Engineering Instrument, including those acting through Holding Funds, as well as description of their selection process;
   (c) dates of payments and amounts of the assistance from the Structural Funds and National Co-financing paid to the Financial Engineering Instrument;

(d) dates and corresponding amounts included in statements of expenditure submitted to the Commission and dates and amounts reimbursed by the Commission;
(e) amounts of the assistance from the Structural Funds and National Co-financing paid by the Financial Engineering Instrument.

For UDFs, these agreed monitoring structures need to be articulated within Level II Funding Agreements, as required by Article 43(3) (b) of the Implementing Regulation. Where a HF exists, the structure needs to be based on the Level I Funding Agreement (Article 44(2) (d) and (f) of the Implementing Regulation). To support the MA in its monitoring obligations, UDFs are also required to allow the MA to access the necessary information and documents.

The box below provides examples of the varied approaches to monitoring that have emerged for JESSICA Operations currently in place. It indicates that some MAs provide direct support for monitoring to UDFs, while others employ a more hands-off approach.

Examples of Varied Managing Authority Monitoring Practices for FEIs

- In the Czech Republic, a member of the MA is on the board of the UDF providing direct support for the Urban Project monitoring process.
- In Greece and Bulgaria, MAs intend to carry out regular monitoring visits to verify progress of UDF monitoring activities.
- Other MAs limit involvement to a review of interim reports (e.g. 6-monthly or quarterly) combined with occasional monitoring visits.

Article 60 (c) (d) and (f) of the General Regulation, provide some specifics on systems that need to be in place for monitoring. It states that MAs are responsible for:

"(c) ensuring that there is a system for recording and storing in computerised form accounting records for each operation under the Operational Programme and that the data on implementation necessary for financial management, monitoring, verifications, audits and evaluation are collected;

(d) ensuring that beneficiaries and other bodies involved in the implementation of operations maintain either a separate accounting system or an adequate accounting code for all transactions relating to the operation without prejudice to national accounting rules;

(f) setting up procedures to ensure that all documents regarding expenditure and audits required to ensure an adequate audit trail are held in accordance with the requirements of Article 90 on the availability of documents (outlined in section 4.1.5 of this chapter on Resourcing and Delivering Monitoring Activities).

UDFs must be aware of these regulations when developing their processes for monitoring. They should also ensure that there is agreement across JESSICA Operations on who is responsible for the storing of accounting records as per Article 60(c) of the General Regulation.

4.1.2 Monitoring of Grants in Operational Programmes

Understanding existing procedures used in the monitoring of grants within OP provides a useful insight for UDFs on how to set up monitoring procedures. These procedures are well understood and actively in use. Suitably adapted to take into account the fact that the focus of monitoring where operations are implemented through Financial Engineering Instrument is the instrument, i.e. the UDF, and not the Final Recipient / Urban project, they can inform the monitoring approach for JESSICA Operations.

Programme Level vs. Project Level Monitoring

OP monitoring takes place across all actors responsible for OP resources (the Commission, Member States, Programme Secretariat and Urban Project manager) and covers several processes:

- At programme level it covers programme payments and effects of the OP;
- At project level, e.g. the equivalent of final recipients in the case of JESSICA Operations, it includes ensuring that an Urban Project proceeds as per the grant funding offer letter or agreement and payments are made only when justified.

In general, the Commission focuses on the financial and physical progress of a programme and priorities within the OP. In this context, MAs have the responsibility to report the programme performance to the Commission on an annual basis, through the following reports:

- Annual Implementation Report – describes the activities performed, including Urban Projects approved and payments effected;
- Annual Control Report – information on management and control systems.

In contrast, Urban Project monitoring in the case where grants are employed has a greater operational focus. Its aims are to:

- Check that Structural Funds are used for the purposes for which they are made available and that conditions for their provision to Urban Projects comply with EU regulations;
- Ensure that funding is paid by a UDF to an Urban Project when a claim meets the terms set in the offer letter / agreement and the Urban Project is proceeding, according to plan;
- Deal with Urban Projects which fail to meet forecasts. Actions can range from the recovery or reduction of resources to full payment where expenditure targets are met and the outputs continue to represent sufficient value for money;
- Provide the basis from which the evaluation of the benefits achieved by overall OP support can be assessed.

Monitoring Protocols and Systems

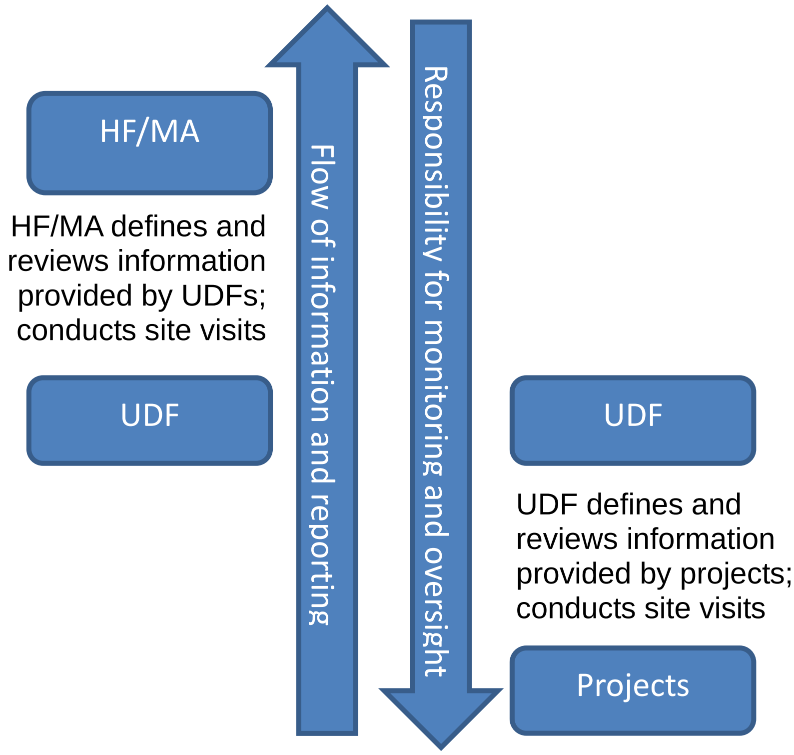
The general protocols for OP monitoring, where grants are employed include:

- Conducting in-depth monitoring – all Urban Projects need to be checked in detail to ensure all targets and milestones are being met;
- Keeping track of Urban Projects – early checking is required to ensure problems with Urban Projects are discovered, including progress reporting and inspection visits;
- Conducting site visits to Urban Projects – there is a presumption that all Urban Projects will be visited during the monitoring period (a sample of Urban Projects may be taken if the MA has a high degree of confidence in the monitoring systems);
- Recording information – standardised reporting fiches should be used for all gathered information, which is required to be up to date for contributing to programme reporting requirements

The extent to which a MA carries out these activities varies. For instance, final recipients are generally required to retain details on all activities, whereas intermediate bodies may only conduct spot checks of a sampling of Urban Projects having reviewed interim reports. In some cases, MA may provide some monitoring assistance to Urban Projects to support the accuracy of information gathered and increase accountability.

4.1.3 Monitoring Specifics for UDFs

At a basic level, UDF monitoring tasks may be defined by the UDF reporting requirements to the HF or MA and follow up activities required by the HF/MA before and after receipt of reports. These requirements typically dictate the upward flow of monitoring responsibilities from the UDF to the HF/MA, and the downward flow of activities UDFs will need to administer towards Urban Projects. The following graphic illustrates this split between upward and downward UDF activities.



It is important to note that the base of responsibility for the upward and downward activities differs and different bodies are responsible for driving the activities. These are outlined below:

- **For upward Monitoring activities** where the UDF reports information up to the HF/MA, the HF/MA propels the process by setting monitoring requirements and timelines. The HF/MA is responsible for holding the UDF accountable for the timeliness and accuracy of information, plus the progress of Urban Projects;

- **For downward monitoring activities** where Urban Projects report information to the UDF, the UDF propels this process by setting monitoring requirements and timelines for Urban Project promoters. The UDF is responsible for holding Urban Projects accountable for the timeliness and accuracy of information and their progress.

As such, the UDF plays a *responsive* role to HFs/MAs during the upward flow of monitoring activities, and a *driving* role during the downward flow of monitoring activity to Urban Projects. In both scenarios, the UDF will need to set up internal systems for information collection, reporting and oversight that support both processes.

The following section proposes a good practice structure based on a review of available information from a number of early processes being established for UDFs, including those set up by HFs managed by the EIB. The system proposed here distils the principles from these early UDFs to create a framework for UDF monitoring. Each UDF will need to adapt the structure to account for the specific nature or typology of their UDF, the broader JESSICA Operation in their region, and their regulatory framework.

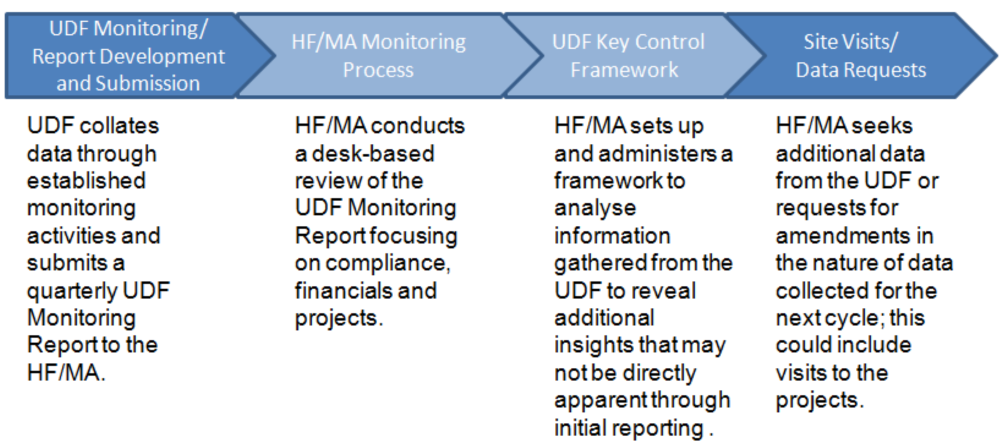
The proposed process does not outline a difference in monitoring for cases where HFs exist or are not used. Rather, it assumes that HFs and MAs are likely to assume similar monitoring roles for UDFs.

4.1.3.1 Upward Flow of Responsibilities to Holding Funds

The following section outlines a proposed 'upward flow' monitoring process based on a six monthly HF/MA monitoring cycle[35], in which the HF/MA drives the process and the UDF takes on a responsive role. In this scenario, the UDF will need to produce and submit a report every six months to the HF/MA, after which the HF/MA reviews the report focusing on compliance, financials and Urban Projects.

Having developed a further understanding of the UDF, the HF/MA will set up a UDF Key Control Framework, which is a series of checks for analysing the success of the UDF and conduct necessary interventions (described in further detail below). This is followed by additional data requests, visits to the UDF to confirm findings and feedback on how information should be collected for the next cycle. If irregularities or Urban Project issues are identified, these will need to be addressed (as explained in further detail in section 5.2 on irregularities reporting).

The graphic below illustrates the monitoring process divided into four phases. The sections in dark blue indicate those areas where the UDF takes active responsibility for monitoring tasks. The sections in light blue indicate those areas where the HF/MA will be reviewing information received from UDFs, in which the UDF does not participate. All sections are included here to provide clarity across the process.



UDF Monitoring/ Report Development and Submission

[35] Regulations require MAs to produce an Annual Implementation Report and Financial Control Report each year, as well as monitoring information referred to in Section 2.7 the General Regulation" (COCOF Note 3) and Article 43(3)(b) of the Implementing Regulation;.

During this stage, the UDF will need to collate data on the progress of Urban Projects they invest in (the final recipients of Loans, Equity, or Guarantees through JESSICA Operations) as well as the management of the UDF as a whole. The monitoring system or process selected by the UDF will need to collect and hold periodic Urban Project information utilised to determine if Urban Project execution is on schedule per agreed targets. This includes Urban Project progress, regulatory compliance and financial progress. If execution is behind schedule, the monitoring system should show that interventions are necessary to keep execution on track. Regarding expenditure, it is important that the UDF and all Urban Project partners demonstrate that expenditures are eligible as defined by OPs.

As a Holding Fund, responsible for the monitoring of a number of UDFs, the EIB has developed a Monitoring and Reporting Template for UDFs, which can serve as an indicative framework for the information UDFs need to collect:

European Investment Bank Overview Monitoring and Reporting Template for UDFs operating with loan agreements from EIB operated Holding Funds

A1 Projects	Overview at Urban Project Level. One Urban Project may be financed through one or more loans.
A2 Loan portfolio	Overview at Loan level. Details of new loan contracts signed with final recipients. (Signature date, JESSICA + UDF National Co-financing amount signed, interest rate, maturity, repayment frequency, etc.)
A3 Disbursements of Loans	Disbursements of Loans to final recipients made by a UDF. (Disbursement date, JESSICA + UDF National Co-financing disbursed, etc.)
A4 Repayment of Loans	Repayments of Loans from final recipients. (Repayment date, JESSICA + UDF National Co-financing principal repaid, JESSICA interest repaid, etc.)
A5 Outstanding amounts	Cumulative data as from the start of reporting. Comprehensive view of all loans and their status (signed, extended, repaid, cancelled, etc.). (JESSICA principal + interest outstanding, status of the loan, etc.)
A6 Loans overdue	Loans overdue more than 30 days. (JESSICA principal + interest overdue >30, >60, >90 days, default interest outstanding, amounts written off, guarantee amounts paid, etc.)
A7 Recoveries of Loans	Recoveries made on terminated contracts. (JESSICA principal + interest recovered, UDF national co-financing principal recovered, default interest recovered, recovered amounts applied to other expenses of the UDF, etc.)
A8 Final recipient	Detailed information about final recipients (FRs). (FR address, NACE code, registration number/personal code, etc.)
A9 Other Address	In case an Urban Project covers several addresses. (Additional Urban Project addresses)
A10 Fund movements	Overview fund movements in the Disbursement and Reserve Accounts. (Resources received from/returned to HF, interest earned and accrued, disbursements of JESSICA loans, repayments from FRs, settlement of management and guarantee forms, etc.)
B Management fees	UDFs management fee calculation. (Management fee calculation of the UDF in line with terms as set out in the Level II Funding Agreement with the HF. No specific instruction given, UDF can present the calculation in their own way)
B Guarantee fees	UDFs Guarantee fee calculation. (Guarantee fee calculation of the UDF in line with terms as set out in the Level II Funding Agreement with the HF. No specific instruction given, UDF can present the calculation in their own way)
B Action plan	List of Urban Projects in difficulties and description of envisaged “action plan” to solve/mitigate the issue.
B Output indicators	Information on Output Indicators and results/achievements to date.

MAs or other HFs not administered by the EIB may develop a variation of the above for their UDFs or make use of the Template Monitoring Report included in Annex II of COCOF Note 3. This template may also serve as a guide for what UDFs should monitor or a regular basis. However, this template only outlines the ***minimum*** amount of information required and is likely to be expanded upon by a MA to reflect the particular characteristics of its JESSICA Operations.

Template Monitoring Report - Primary Headings

- General information on the UDF
  - Name of UDF
  - Geographical scope
  - Short description of UDF
  - Short description of Investment Strategy
  - Other details on UDF Fund Managers date of UDF inception, etc.
- Contributions to the UDF
  - Contributions received from the HF
  - Contributions received from public and private co-financing
  - Additional resources contributed to the UDF (other than from the HF)
- Investments / Financial Products provided to final recipients (Urban Projects) – this detail is provided by Urban Project
  - Loans provided
  - Guarantees provided
  - Equity/ Venture Capital provided
  - Other products provided
- Income Receipts and Capital Receipts and Recycling
  - From Loans
  - From Guarantees
  - From Equity/ Venture Capital
  - From other products provided
- National co-financing and leverage resources provided at Urban Project level
- Management Costs and Management Fees (also note compliance with maximum limits)
- Exits from the UDF
  - Total amount of each exit realised and effectively paid back to the UDF
  - Total amount of each exit realised and paid to other shareholders
- Other indicators
  - Number of Urban Projects supported
  - Total amount of leveraged/mobilised resources as a result of the level of ERDF funding provided
  - Number of jobs created and/or safeguarded
  - Other

It will be up to the UDF to work with HFs/MAs to agree the content of the reports. Based on what is agreed, the UDF will need to define appropriate systems for capturing the information including which data they can collate on their own or from Urban Projects, and at what interval of time.

Furthermore, UDFs will need to assign dedicated resources responsible for data collection and reporting. The number of staff needed will depend on the typology of the UDF and its Investment Strategy, which may also have implications for the system selected for data collection.

HF/MA Monitoring Process

Once the UDF Monitoring Report is submitted, the HF/MA will typically launch three distinct activities:

1) Compliance Monitoring – The HF will review the UDF's on-going compliance with the Level II Funding Agreement, taking into account Structural Fund regulations.

2) Financial Monitoring – The HF will conduct a plausibility check, which aims to review, analyse and verify the UDF report; and employ a methodology to identify key indicators on how to measure UDF outcomes and progress.

3) Urban Project Monitoring – The HF measures Urban Project performance and the success of operations (including how to deal with irregularities and with problematic cases identified during reporting).

These above activities will be conducted mostly off-site by the HF/MA based on the UDF Monitoring Report, submitted quarterly in this scenario. As such, the UDF will need to make sure that the information provided is thorough and complete to enable a robust review.

UDF Key Control Framework

This phase results from the initial HF/MA review of the UDF Monitoring Report. Having understood further detail on UDF operations and Urban Project progress, the HF/MA develops a methodology for conducting a more thorough assessment of data; this assessment is called the UDF Key Control Framework. The framework is intended to reveal additional insights on the UDF and Urban Projects that may not be directly apparent through initial reporting and can include, for example, statistical analysis of a sampling of financial data to identify the general pattern of expenditure and outlier cases of expenditure. It could also include guidelines for conducting on-site visits for the verification of data and how they may be used to enhance the overall monitoring process.

This is a crucial stage in the monitoring process by HFs, as it results in the development of assessment and intervention criteria for the UDFs, which can vary widely dependent on their investment focus and structure. (See UDF Typologies Study for a discussion on the varied types of UDFs that could be developed).

This design of the UDF Key Control Framework is likely to be a significant task for the HF during the early stages of monitoring when the framework is initially being developed. Once the framework has been tested, changes may be minimal during further monitoring cycles allowing key controls to be carried out in a routine manner.

Urban Project Visits and Data Requests

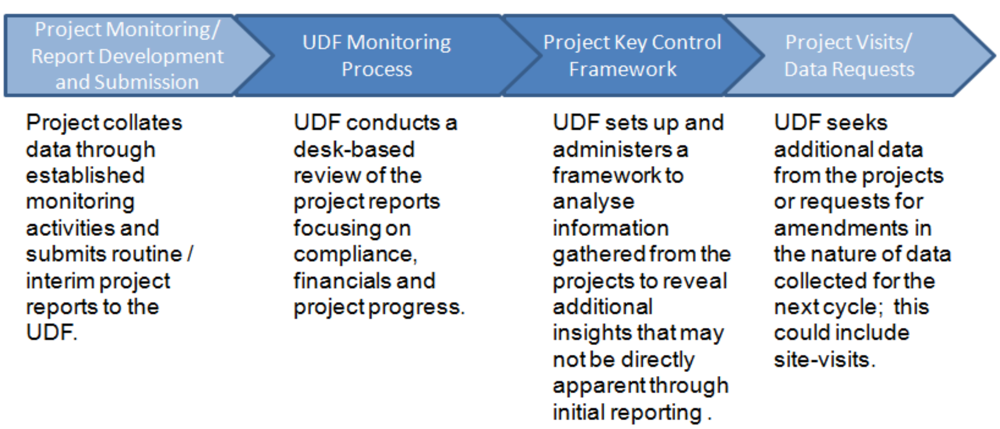
Following the UDF Key Control Framework review, the HF/MA may conduct site visits or request additional data to supplement the UDF Monitoring Report. The number of site visits will depend on the MAs assessment of the prevailing control environment and the effectiveness and accuracy of information it provides. UDFs will need to be prepared to cooperate with these activities.

4.1.3.2 Downward Flow of Responsibilities to Urban Projects

The downward flow of UDF monitoring activities towards Urban Projects mirrors the process between the UDF and the HF/MA but in the opposite direction. The UDF is the key driver of this process responsible for defining information needs and collecting information from the Urban Projects, with Urban Projects taking on a responsive role. In this scenario, the UDF will need to clearly articulate the type of information Urban Projects need to track and collate, set up a process for review to ensure that the information provides the necessary insights, and set up a process for intervention when Urban Projects are not running to plan.

As above, the downward monitoring cycle outlined here assumes a six monthly process, but it will ultimately be up to the UDF to decide the intervals for monitoring recognising its obligations under the regulations. UDFs should set this timeline based on what they need to develop the UDF Monitoring Reports for HFs/MAs and how much time they need to intervene when issues occur. It is likely that this process will be driven by the UDFs own obligations to its HF or MA.

The graphic below illustrates the downward process divided into four phases. Each phase is described in further detail. The sections in dark blue indicate those areas where the UDF is most active. The sections in light blue indicate those areas where Urban Projects need to conduct Urban Project specific monitoring tasks, gather Urban Project data and produce interim reports. All sections are included here to provide clarity across the process.



Urban Project Monitoring/ Report Development and Submission

During this stage, Urban Projects will need to collate data on the progress of developments, and it will be up to the UDF to define what these details need to be. These are likely to be based on what is required for the Monitoring Report submitted by the UDF to the HF/MA.

UDFs will require openness from final recipients to certify accuracy of the information provided. UDFs need to anticipate Urban Project risks as they arise, which could occasionally include Urban Project details not initially defined in the Level II Funding Agreement, but which could be crucial to success.

All details for Urban Project monitoring will need to be outlined clearly for each Urban Project receiving UDF investment and included within applicable Investment Agreements. final recipients / Urban Projects will need to implement appropriate mechanisms for project data collection and analysis based on these agreements.

UDF Monitoring Process

This process is linked to the production of a UDF Monitoring Report, normally to comply with Level II Funding Agreement obligations. It may be more appropriate for the UDF to monitor on a rolling basis, perhaps sporadically across Urban Projects in the case of a UDF issuing many small investments. It is essentially up to the UDF to set up the timeline for this process as it so chooses, as long as it allows the UDF to review the Urban Projects.

The desk-based review should include the following:

1) Compliance Monitoring – The UDF will review the Urban Project's on-going compliance with the Investment Agreement, taking into account Structural Fund regulations and OP requirements, particularly around Urban Project expenditure eligibility.

2) Financial Monitoring – The UDF will conduct a plausibility check, which aims to review, analyse and verify the Urban Project reports; and, employ a methodology to identify key indicators on how to measure Urban Project outcomes and progress.

3) Urban Project Monitoring – The UDF measures Urban Project performance and the success of operations (including how to deal with irregularities and with problematic cases identified during reporting).

This is the stage in which a UDF will need to actively review Urban Project information to ascertain success and risks against objectives and the accuracy of information on expenditure. It will be important for the UDF to develop a review methodology and engage the HF/MA in its development so that criteria are consistent. This process of on-going Urban Project review and

HF/MA engagement should help to reduce review discrepancies up and down the monitoring process.

Urban Project Key Control Framework

The UDF will need to develop an Urban Project Key Control Framework, apply this framework to review the success of Urban Projects and conduct necessary interventions. As with the HF/MA, this framework is intended to reveal additional insights on Urban Projects that may not be directly apparent through initial reporting. This may include statistical analysis of financial data to identify general patterns of expenditure and outlier cases, which could highlight issues for further investigation. It may also include guidelines for conducting on-site visits for the verification of data and how they may be used to enhance the overall monitoring process.

The following are several statistical measures that could be used for the review of Urban Projects:

1) Ratio Analysis identifies Urban Projects in which the distribution of costs amongst the various cost categories deviates from the average distributions within their peer group (e.g. other Urban Projects). The analysis could include the ratios listed below, which are currently in use at other Structural Fund programmes. The UDF may want to identify which ones will be most appropriate for Urban Project monitoring purposes.

    a. Commission assistance/total Urban Project cost
    b. Urban Project cost/personnel cost
    c. Urban Project cost/fixed assets
    d. Urban Project cost/administration costs
    e. Urban Project cost/representation and travel
    f. Urban Project cost/subcontracting costs
    g. Urban Project cost/seminar event
    h. Urban Project cost/research
    i. Urban Project cost/marketing
    j. Urban Project cost/other costs
    k. Urban Project cost/exceptional costs
    l. Personnel cost/ fixed assets
    m. Commission financial assistance/Urban Project income
    n. Commission financial assistance/other contributions
    o. Commission financial assistance/ beneficiary turnover (Urban Project level)
    p. Commission financial assistance/ beneficiary turnover (overall)

2) Urban Project Sanity Checks identifies Urban Projects or Urban Project expenses with unusual characteristics. The checks are performed on the level of individual expenses (round amounts, duplicates, timing, etc.) and on the master data level (e.g. incomplete master data on beneficiaries, sub-contractors, etc.). This could include checks listed below which are currently in use in other Structural Funds programmes. The UDF will need to identify which ones will be most appropriate for Urban Project monitoring purposes.

a. Round amounts
b. Duplicate amounts
c. Negative expenses
d. Expenses higher than assistance
e. Urban Project costs outside eligible period – before start date
f. Urban Project costs outside eligible period – after start date
g. Missing cost allocations
h. High percentage of cost allocations before Urban Project end date
i. Missing critical information on beneficiaries

3) Cross Urban Project Testing identifies Urban Projects with unusual characteristics by comparing information from different Urban Projects or programmes. This could include tests listed below which ones are currently in use at other Structural Funds programmes. The UDF will need to identify which ones will be most appropriate for Urban Project monitoring purposes.

   a. Beneficiaries with multiple Urban Projects
   b. Beneficiaries involved in multiple programmes
   c. Sub-contractors linked to multiple Urban Projects
   d. Sub-contractors linked to multiple Urban Projects/same beneficiary
   e. Personnel linked to multiple Urban Projects
   f. Management linked to multiple beneficiaries

4) PEP and Blacklist Testing identifies beneficiaries, management, employees or sub-contractors within Urban Projects which may be listed (or blacklisted) on portals such as “World Compliance”.

In addition to the above statistical measures, the UDF could require Urban Projects to ‘self-certify’ the accuracy of their reports to provide additional assurance.

When developing the Urban Project Key Control framework, it will be important for UDFs to ascertain an appropriate *volume* of control activities. For instance, while UDFs with a small number of large Urban Projects may be able to conduct control activities for each Urban Project, UDFs with a large number of small Urban Projects may only reasonably be able to conduct controls over a selection of Urban Projects. In the both cases, the use of random sampling standards is recommended. The issue of appropriate volume is also relevant to the process for selecting Urban Projects for site visit targets, as UDFs with many small Urban Projects may not feasibly be able to see all Urban Projects at each monitoring cycle.

Developing and routinely refining the Urban Project Key Control Framework is crucial in this stage of the UDF monitoring process, as it results in the development of appropriate assessment and intervention criteria for the distinct Urban Projects, which can vary widely. As with the HF/MA, this stage is likely to be significant during the early stages of monitoring when the UDF Key Control Framework is being developed. Once the framework has been tested and refined during early monitoring cycles, changes may be minimal, and the administration of key controls may occur in a routine manner.

Urban Project Visits and Data Requests

Following the administration of Urban Project key controls, UDFs conduct site visits or request additional data from Urban Projects to further verify Urban Project successes and risks. The UDF Fund Manager will have to establish the effectiveness of the control system in place within each Urban Project to determine if they can rely on the information provided through monitoring. For those UDFs undertaking a small number of large investments, it may be more efficient for the UDF Fund Manager to undertake site visits for all Urban Projects.

The aim of the site visits and additional data requests are to check Urban Project organisation and finances, and review whether the Urban Project activities have been successfully executed. During site visits in particular, UDFs should ascertain whether there are problems in the implementation of Urban Projects and ask Urban Project managers if they can offer any help in finding solutions to problems faced. Site visits should also check whether necessary publicity and communication activities have been implemented.

The following is a sample list of checks to potentially include in a site visit. A UDF may choose to check only a selection of the items below, depending on the outcomes of the Urban Project report review and Urban Project Key Control Framework activities.

1) Urban Project organisation
    a. Organisation of Urban Project and division of tasks
    b. Personnel and Urban Project partners (such as the key personnel employed by a project promoter)
    c. Administration system and file-keeping
2) Progress of the Urban Project
    a. Urban Project data and planning
    b. (Adherence to) milestones and timelines
    c. Other success indicators against stated programme outputs (for example, energy efficiency components of a Urban Project)
    d. Publicity activities
3) Financial progress
    a. Income Receipts and Capital Receipts and expenditures
    b. Internal maintenance budget
    c. Fulfilment of financial conditions
    d. Instructions for the auditor
    e. Compliance rules for public procurement and competition rules
4) Reporting and monitoring
    a. Process for monitoring and report development

All Urban Projects will need to be prepared to cooperate with the site visits and accompanying UDF representatives on site visits if need be. UDFs should agree a timeline with Urban Projects for notice of site visits and data requests, for example a minimum of 2 weeks. Where a large number of Urban Projects are being supported, a UDF may decide to visit only a sample of Urban Projects each monitoring cycle within a year. Where sampling procedures are used, it should be ensured that a good balance of Urban Projects are visited and UDFs will need to set up a Risk Assessment process for all Urban Projects so that more monitoring resources can be focused on Urban Projects with a higher risk of problems. UDFs will also need to keep reports of all site visits containing a description of checks performed, the results of these checks, corrective actions agreed upon and recommendations for the Urban Project.

Finally, UDFs may use this stage to request amendments to an Urban Project's information reporting or provide feedback on the monitoring mechanisms currently in place. UDFs would also be expected to integrate any other feedback from the HF/MA on how to improve Urban Project reporting. UDF monitoring responsibilities are likely to require a significant level of attention year-round. The UDF will need to carefully define roles and responsibilities, and set expectations for monitoring across all involved so that it has access to timely and accurate data.

4.1.4 UDF Resourcing for Monitoring Activity

As already mentioned, UDFs will need to assign staff to carry out monitoring activities and support Urban Projects with their monitoring tasks. Responsibilities will include set up of monitoring controls and data collection, conducting site visits, and report drafting, in addition to other related activities.

Some HFs/MAs may require that a member of the Programme Monitoring Committee be integrated as a part of the UDF Monitoring team. This role may take on an oversight function or actively participate in monitoring activities. UDFs will need to agree with the MA on whether the cost of monitoring activities should be included within Management Costs or be funded, wholly or in part, by the MA.

4.1.5 Retention of Monitoring Information and Documentation

UDFs hold primary responsibility for the retention of documentation and evidence necessary to prove Urban Project compliance with EU and national rules, regarding the resources applied. COCOF Note 3 refers to specific examples of supporting documentation which need to be held to evidence compliance with EU and national rules:

- supporting documents of the establishment of the Financial Engineering Instruments (i.e. State Aid rules, public procurement rules, legal agreements, etc.);
- supporting documents of the functioning of the Financial Engineering Instruments (i.e. use of Gains, Income Receipts and Capital Receipts, etc.);
- supporting documents on the Management Costs and Management Fees;
- application forms submitted by Urban Projects with supporting documents, including Business Plans and previous annual accounts, checklists and reports of the financial intermediaries (such as Financial Institutions, venture capital funds etc.);
- declarations made in connection with receipt of any De Minimis State-aid;
- signed agreements in relation to the Repayable Investments (including Equity, Loans Guarantees or other forms of Repayable Investments provided to enterprises, public private partnerships, Urban Development Projects, or to legal or natural persons carrying out specific investment activities in energy efficiency and use of renewable energy in buildings);
- evidence that the objectives for which the Repayable Investments were used have been achieved according to the intended purpose (e.g. documents provided by final recipients as appropriate, reports on the spot verifications by Fund Managers, visits and board meetings, annual accounts, etc.).

The guidance further states that there must be "proof of the financial transfers from the Financial Engineering Instrument to the final recipients or in the case of Guarantees, proof that underlying Loans were disbursed" which in this case the UDF needs to be responsible for.

Article 90 of the General Regulation states that MAs need to ensure that all the supporting documents regarding expenditure and audits are kept available for the Commission and the Court of Auditors for: *"(a) a period of three years following the closure of an Operational Programme as defined in Article 89(3); and (b) a period of three years following the year in which partial closure took place in the case of documents regarding expenditure and audit on Operations..".* It should be noted that these timescales operate exclusive of obligations to retain documents for State Aid purposes. For example, De Minimis aid declarations are required to be retained for 10 years from the date of funding. Deadlines should also be subject to the duration specified within Level II Funding Agreements.

4.2 Management Verifications

In the context of FEIs, Article 13(2) of the Implementing Regulation places a requirement on the MA to carry out checks on the administrative, financial, technical and physical aspects of the expenditure made through ERDF operations. Verifications are undertaken only by the MA and must ensure that[36]:

- expenditure declared is real;
- Operations have been delivered in accordance with the approval decision; and
- Operations and expenditure comply with EU and national rules.

The management verifications are therefore part of the control system described in the introduction to this chapter and compare the actual activities occurring with the information transmitted by the monitoring and reporting systems.

MAs are responsible[37] for managing and implementing OPs and ensuring the principle of sound financial management of ERDF resources[38]. In particular the MA must:

- Ensure operations selected for funding are in accordance with the OP and comply with EU and national rules;
- Verify that co-financed operations are delivered and properly declared on statements of expenditure to the Commission;
- Ensure that the Certifying Authority receives all necessary information on procedures undertaken by the MA to ensure accurate recording of expenditure, for certification purposes;

[36] DG REGIO - Guidance note on management verifications to be carried out by member states on operations co-financed by the structural and cohesion fund for the 2007 - 2013 programming period.

[37] MA are permitted to delegate some of the work of verification to third parties where considered appropriate, but it is not allowed to transfer its responsibility for verifying monitoring and reporting information as set out in Article 13 of the Implementing Regulation

[38] As set out in Article 27 of Regulation 1605/2002

- Ensure compliance with information and publicity obligations.

Each MA has the responsibility to document its management verification process and provide guidance to beneficiaries (i.e. UDFs) and possibly final recipients / Urban Projects). It is therefore recommended that UDFs review this guidance as part of designing their own control systems and procedures.

Specific Management Verifications for JESSICA Operation

The following list illustrates some of the practical areas of verification that a MA may decide to undertake:

- An examination of the transparency of the procedure to select the UDF and where applicable appoint the UDF Fund Manager;

- An examination of the transparency of the process used by the UDF to select Urban Projects for investment;

- Periodic review of investments made by UDF to ensure OP resources are being invested in accordance with OP objectives;

- Periodic review that State Aid provisions are not being breached;

- An examination of the reporting and monitoring processes undertaken by the UDF to test timeliness and accuracy of information provided to the MA or HF.

4.3 Audit

An audit is a planned process, looking at both financial and non-financial records, with the aim to enable an auditing agency to express an opinion on these records. Audits seek to provide reasonable assurance that information is free from material error and obtain reasonable assurance that the management and control systems relating to the UDF are functioning effectively to prevent, detect and correct irregularities in a timely manner.

Audits are normally performed by professionally qualified independent auditors and as such the UDF will not be in a position of self-certifying its operations. The audit of UDF operations covers a number of facets, some pertaining to ERDF Regulations and other based on statutory or legal requirements within the country of residence of the UDF:

- As a party in the implementation of OP objectives, the UDF will be part of the auditing process undertaken on the use of ERDF resources to this effect. The ERDF OPs are subject to a series of audit processes outlined in EU regulations which require the UDF to operate monitoring and reporting systems (as described elsewhere in this chapter) and submit its activities to scrutiny by the MS or the Commission.

- As a separate legal entity (or block of finance within an existing financial institution) the UDF will have to comply with MS law on the auditing of the financial reports it produces.

The remainder of this section will elaborate on the Commission's approach to auditing Financial Engineering Instruments and its implications for UDFs.

4.3.1 Overview of the Commission's approach to Audit

In July 2011, DG Regional Policy published a manual entitled "Common Audit Framework - Financial Engineering Instruments in the Context of Structural Funds". The document provides guidance for the audit of Financial Engineering Instruments established under Article 44 of the General Regulation. The manual also states it provides comprehensive briefing and guidance to Commission and national auditors who are undertaking the planning, fieldwork and reporting stages of an audit.

It is therefore recommended that MA's, HFs and UDF Fund Managers utilise the Common Audit Framework Manual as the main reference point for all matters pertaining to the audit of UDFs. This section of the handbook summarises the main points of the UDF audit process defined by the Common Audit Framework Manual and assumes the reader will refer to it for definitive guidance.

Section 6.1.1 of COCOF Note 3 states that "supporting documents for expenditure by the Structural Funds is required in order to establish an adequate audit trail and to provide evidence on the use of the funds for the purposes intended to, observance of the applicable EU and national rules and legislation as well as criteria and conditionality attached to the funding provided under the relevant operational programmes." UDFs need to produce supporting documents to enable the Commission to verify the legality and regularity of expenditure and demonstrate that sound management principles have been consistently applied.

Any audit of Financial Engineering Instruments will cover the basis of their establishments (i.e. compliance with State Aid rules, public procurement etc.), the basis on which its functions (use of Income Receipts and Capital Receipts etc.) and the basis on which investments are made.

Audit obligations are set out in Article 16 of the Implementing Regulation and include verification that each:

- *"Operation meets the selection criteria for the Operational Programme, has been implemented in accordance with the approval decision and fulfils any applicable conditions concerning its functionality and use or the objectives to be attained;*
- *Expenditure declared corresponds to the accounting records and supporting documents held by the beneficiary;*
- *Expenditure declared by the beneficiary is in compliance with Community and national rules;*
- *Public contribution has been paid to the beneficiary in accordance with Article 80 of the General Regulation."*

This will include in all cases verification that expenditure is in line with eligibility rules and the requirements of Article 78(6) of the General Regulation regarding expenditure incurred.

Different levels can be audited, although at the Urban Project level this is only the case where relevant documentation is not available at the UDF level. The audit process for UDFs entails two types of objective:

(1) Legality and Regularity

Regarding legality and regularity objectives, auditors will need to provide assurance to the MS and Commission on:

- compliance with all applicable regulations, both European and National;
- consistency with applicable Commission guidelines and interpretations;
- statement of expenditure and associated reporting presented accurately, in all material respects;
- proper and effective management and control over UDF operations.

(2) *Sound Financial Management Objectives*

In the context of the sound financial management considerations the auditor of a UDF is required to look at elements of economy, efficiency and effectiveness:

a) Economy concerns reliance on sound administrative principles and practices, such as:
- Value for money through competitive selection of the UDF;
- Value for money with respect to Management Costs and Management Fees;
- First Round Investments with a good opportunity for returns.

b) Efficiency concerns the efficient utilisation of human, financial and other resources, including but not limited to:
- The leverage obtained from financial sources other than those from the OP as a result of the use of ERDF resources;
- The extent of recycling of ERDF resources by the UDF.

c) Effectiveness concerns the ability by the UDF to achieve its objectives and demonstrate that the actual impact from activities meets the expectations for the intended impact.

Beyond the verification of compliance with the regulatory framework and the accuracy of transactions, the wider objective of a UDF audit is to form an opinion of whether a satisfactory use of ERDF resources has been achieved in terms of outputs and results.

4.3.2 What will be audited?

Typically a UDF will be subject to at least three different types of OP audit:

1) Systems audit at the beginning of the OP
2) Annual operations Audit of OP activities
3) End of OP Audit

Additionally there will be other audit requirements summarised in the following chart:

Entities which may conduct an audit of a UDF

Commission Audit Requirements	Other Audit Requirements
The Project Inspection and Verification team. In order to comply with the requirements of Article 60 of the General Regulation every Managing Authority is to establish a Project Inspection and Verification team (PIVT) which monitors programme compliance with Commission and National rules.	**National Audits.** The UDF will be subject to statutory audit compliance in line with national laws. Depending on their legal status and where required by national law UDFs will need to produce financial statements which include an official opinion

The PIVT is expected to visit the UDF within six months of it being established and is likely to carry out further visits throughout the life of the UDF. **The Audit Authority (AA)** Article 62 (b) of the General Regulation requires Managing Authorities to also have an independent Audit Authority (AA). This body's role is to monitor the performance of the Managing Authority, but it may also wish to audit UDFs to support its overall audit of the MA. **European Commission ERDF Auditors.** ERDF Auditors of the European Commission also have the authority to undertake audits of any Urban Project funded by ERDF. UDFs may also be included within broader ERDF audits but this may be a rare occurrence. Commission officials may also carry out on-the-spot checks, including sample checks, on the operations and on management and control systems. **Certifying Authority.** The Certifying Authority may conduct Follow Up Checks based on the outcomes of previous audit activities if additional verifications are needed.	of their auditors. **Government Audit Bodies.** Since UDFs are likely to receive public monies (e.g. in the form of National Co-financing) to comply with national laws, UDFs may also be audited by Government Audit Bodies.

4.3.3 Typically Requested Audit Detail

Audit evidence is used by an auditor to determine whether the information is accurately stated and in accordance with established criteria. There are two determinants as to whether audit evidence is persuasive: its appropriateness / trustworthiness and its sufficiency. Types of acceptable evidence include:

- Documentary evidence
- Physical evidence (for tangible assets)
- Third-party confirmations (e.g. from the UDF's bank)
- Computations/re-calculation where the auditor check the mathematical accuracy of documents and records
- Observation
- Re-performance of a procedure to check internal controls

In terms of documentary evidence, auditing bodies are likely to inspect and/or take copies of all reports, books, accounting records and other documents which they consider relevant to the success of the Urban Project and its compliance with OP objectives. Auditors will use documentary evidence to justify the audit opinion. UDFs will need to fully cooperate and be prepared for information requests during these audit visits.

It is up to the HF/MA to determine the level of audit detail to be mandated. Paragraph 6.1.7 of COCOF Note 3 recommends UDFs cover:

- Supporting documents illustrating the establishment of the Financial Engineering Instruments (i.e. State Aid rules, public procurement rules, legal agreements, etc.). This should include information illustrating that OP, Commission and national funding conditions have been met;
- Supporting documents of the functioning of the UDF (i.e. use of Gains, Income Receipts and Capital Receipts, etc.);
- Supporting documents on Management Costs and Management Fees;

- Application forms submitted by final recipients with supporting documents, including business plans and previous annual accounts, checklists and reports of the financial intermediaries (including Financial Institutions and venture capital fund);
- Declarations made in connection with receipt of *De Minimis* State Aid;
- Signed agreements in relation to the Repayable Investments (including Equity, Loans, Guarantees or other forms of Repayable Investments Urban Projects);
- Documentary evidence demonstrating that the Loans, Equity or Guarantees or other financial instruments were applied to urban development Urban Projects;
- Proof of financial transfers from Financial Engineering Instruments to final recipients, or in the case of Guarantees proof that underlying Loans were disbursed;
- Evidence that the objectives for which the Repayable Investments were used have been achieved according to the intended purpose (e.g. documents provided by final recipients as appropriate, reports on the spot verifications by Fund Managers, visits and board meetings, annual accounts, and reports by the Loan intermediary to the Guarantee fund supporting claims).

The UDF must retain and be able to produce documentation detailing the approval process for money being spent. This will include, inter alia, a review of investee scheme applications, the process for approving schemes, scheme specific business plans, the control environment in operation at the UDF and minutes of meetings. The UDF must retain comprehensive evidence of the review process and documents such as copies of the planning consents, and approval of all regeneration schemes. UDFs will need to record which OP Priority Axis UDF investments are drawn from for specific Urban Projects. This will allow the Commission to easily verify the eligibility of expenditure against Structural Fund regulations and national eligibility rules.

Both Level I Funding Agreements and Level II Funding Agreements should include clear information on specific rules which need to be adhered to and the categories of documents which are required to be kept as an audit trail.

4.3.4 Operational Programme Auditing Activities Affecting the UDF

At the OP level, UDFs will need to be prepared for information requests from the Audit and Certifying Authorities as required to verify the Annual Control Report and support the creation of the initial Compliance Assessment after the initial due diligence stage for the UDF.

At the Urban Project level, UDFs will need to record statements of expenditure and payment requests to accompany interim Urban Project reports, as may be required within the monitoring activities. Normally, a UDF audit will need to check the quality of management and control systems used, the nature of Urban Project expenditures, and ultimately whether value for money has been achieved.

This implies the following responsibilities for UDFs:

- UDFs will need to agree a timeline for payment requests and where necessary statements of expenditure from final recipients / Urban Projects;

- UDFs will need to conduct routine checks or sample testing activities to verify Urban Project expenditure, and thus prepare itself for potential First and Second Level Controls from the Audit and Certifying Authorities;

- UDFs may choose to replicate the HF/MA systems testing in its relationships with the Urban Projects in order to verify the soundness of financial systems in place and in preparation from potential First and Second Level Controls from the Audit and Certifying Authorities.

To help with efforts to verify expenditure, UDFs may employ *sample testing* techniques based on an appropriate sample of expenditure and Urban Projects. As already noted, the Commission no longer has minimum sample requirements but recommends that the sampling size be determined by a random statistical sampling method which in practice falls within the 5-10% range.

As for *systems testing*, it will be important for the UDF to utilise a process that determines if the information systems in place are safeguarding assets, maintaining data integrity and operating effectively to achieve the UDF and programme's objectives. The UDF may employ an external auditor to form an opinion as to whether the systems in place are appropriate, efficient and adequately controlled to ensure reliable, timely and secure inputs, processing and outputs. These reviews may be performed in conjunction with a financial statement audit for the UDF.

As above, the UDF systems testing exercise should be carried out in preparation for the systems test from the MA who will also be responsible for providing guidance to the UDF on the appropriateness of its systems so that it can be rated successfully during future systems audits. The UDF should work with the HF/MA to make sure these systems are outlined and agreed in the Level II Funding Agreement during programme set up.

4.3.5 Requirements for the UDF as a Legal Entity

The above activities have so far outlined financial control and audit activities which are similar to the ERDF normal OP activity and applicable to a UDF. However, UDFs will need to carry out additional activities particularly when they are established as independent legal entities.

For instance, UDFs must prepare annual financial statements which will then be externally audited as with any legal entity in a MS. UDFs will need to submit these annual statutory accounts in line with local laws and include an external audit opinion. UDFs will also have to submit tax returns, complying with local tax legislation.

They may also be subject to national and governmental audits to verify sound financial management and the appropriate use of this body may carry out value for money auditing of any other public resources invested in the UDF.

Audit responsibilities for UDFs combine activities undertaken under the normal OP activity as well as standard auditing requirements for independent legal entities. UDFs will need to take this into account when drafting and agreeing their approach for financial controls and auditing with HFs and Urban Projects. The UDF will also need to take into account any existing audit agreements with the MA and the broader audit strategy for the OP to develop a financial control and audit plan that meets requirements up the chain of responsibility.

4.3.6 UDF Audit Areas

This section summarises the audit areas that will be focused on during any audit of the UDF (as defined by DG Regional Policy's "Common Audit Framework – Financial Engineering Instruments in the Context of Structural Funds").

Design of FEI

The audit checks will review information available on the set up and implementation of the UDF and overall JESSICA Operations in a MS, in particular to assess if the operations conform to Article 44 of the General Regulation and to Articles 43-46 of the Implementing Regulation.

The auditor will seek to understand the overall architecture of the JESSICA Operations and legal structures involved (such as the HF and UDFs), plus the main responsibilities of each actor in the architecture. As part of this process, the audit will also review the Level I Funding Agreements and Level II Funding Agreements. Section 3.3.3 (a) of the Common Audit Framework[39] outlines suggested minimum provisions that should be in place within Funding Agreements for the auditor to inspect.

Finally, the auditor will need to have a good understanding of how ERDF resources have been made available to JESSICA Operations, including that ERDF and co-financing contributions are made in compliance with the OP and the applicable regulations.

Selection of Financial Intermediaries (UDFs)

The manual Common Audit Framework sets out the legal basis of the procurement of UDFs – Article 44 of the General Regulation, Article 43 of the Implementing Regulation, Commission public procurement directive 2004/18/EC and COCOF Note 3 sections 2.2 and 8.2.

In summary, the auditor is looking to understand that an acceptable procurement route was followed to appoint the UDF (based on permitted Commission and national legal frameworks). The auditor should not only verify the existence of a suitable procurement process, but should also verify a coherent appraisal, selection and accreditation process has taken place to appoint a UDF.

In particular, the auditor is seeking to understand that;

- the appraisal and selection criteria within the procurement process are consistent with the ultimate Funding Agreements entered into;
- specifications of the call for tenders and the selection and award criteria are in line with OP objectives;
- an open, transparent and non-discriminatory process was conducted.

[39] DG Regio: Common Audit Framework – Financial Engineering Instruments in the Context of Structural Funds (July 2011)

Investment Strategy and Design of Products

It is important for both the UDF and statutory auditors to gain a full understanding of each UDF's Investment Strategy as much of their audit work will stem from this. They will need to gain an understanding of the purpose of financing, type of financial products, target market, operational budget, planning, envisaged final recipients and targets to be achieved. A UDF will also need to ensure its consistency with the OP objectives.

The UDF will need to design its own strategy in compliance with the overall HF Investment Strategy and ERDF Regulations, for example, State Aid and procurement. The strategy must also target Urban Projects within the IPSUD. It is recommended that the Investment Strategy include:

- Urban Projects and targets to be achieved;
- Planning;
- Final recipients to be supported;
- Risk management policy e.g. diversification of investment;
- Products key specificities.

The auditors will be looking to check that the Investment Strategy only includes eligible investments/financial products and expenditures. To do this they may use sample testing to check the logic behind the decisions taken.

The UDF may utilise the following financial products: Loans, Equity, Guarantee and mezzanine financing. Once the UDF has selected its products, the UDF will need to be able to demonstrate the following to the auditors:

- Specific characteristics of the selected products;
- Risk management policy;
- Additionality (increase access to finance in qualitative and quantitative terms);
- Envisaged performance and targets set.

The UDF must show that its products are in line with how a UDF should invest in products, as set out in the COCOF guidance notes and Implementing Regulation. The UDF will also need to prove that any additional elements required by the MS or HF have been included. Evidence for this may include confirmation from the UDF's lawyers.

Management Costs

The UDF auditors will need to review that Management Costs fall within the cap rate set out in Article 44 of the Implementing Regulation and claimed in accordance within the applicable Funding Agreement. The Management Costs and Management Fees are not to exceed on average 3% per year of the capital contributed from the OP to the UDF (unless a higher percentage proves necessary following a competitive tender). During the period of the OP, the costs and fees will need to be paid from this 3% (or figure resulting from competitive tender[40]) and from no other source.

[40] Regulation 846/2009 amended Article 43(4) to allow for an uplift to the percentage caps on Management Costs and Management Fees of 0.5% in Outermost regions.

The auditors will also need to check that the Management Costs and fee agreements for fixed costs, activities costs and other costs agreed between UDFs and Urban Projects are also adhered to. (Section 5 of this handbook includes a full description of allowable Management Costs and Management Fees).

Monitoring

Auditors will also need to review monitoring processes to ensure that they comply with regulations and meet the requirements from UDFs on information collection and reporting. Funding Agreements will include definitions of the monitoring procedures between the HF/MA and UDF, and the auditors will need to verify that these have been complied with. (For more detail on the requirements for monitoring, see Section 4.1 on monitoring).

Reporting

The UDF must remain up to date with the agreed timetable for both operational and financial reporting agreed with the HF/MA (*see Section 4.3.2*). The reporting requirements will need to be outlined within Funding Agreements, and auditors will need to verify that timelines have been complied with. Spot checks of both routine and annual reports from the UDFs and Urban Projects will be required to verify their completeness. If necessary, statistical sampling may be used to further review accuracy.

Auditors will also need to review the reports to ascertain any discrepancies between operational and financial reports and the outcome of auditing activities. If any discrepancies are identified, this may indicate weaknesses in monitoring procedures which will need to be addressed.

Audit Trail and Verification

Article 15 of the Implementing Regulation states that:

"*An audit trail shall be considered adequate where, for the Operational Programme concerned, it complies with the following criteria:*

a) It permits the aggregate amounts certified to the Commission to be reconciled with the detailed accounting records and supporting documents held by the certifying authority, managing authority, intermediate bodies and recipients as regards operations co-financed under the Operational Programme;

b) It permits verification of payment of the public contribution to the recipient;

c) It permits verification of application of the selection criteria established by the monitoring committee for the Operational Programme;

d) *It contains in respect of each scheme, as appropriate, the technical specifications and financing plan, documents concerning the grant approval, documents relating to public procurement procedures, progress reports and reports on verifications and audits carried out*".

To meet the above requirements, it is recommended that audit trail procedures are agreed between the UDF and the MA or HF that these details are included within Funding Agreements and audit activities are carried out in accordance with these agreements. For instance, in order to provide an appropriate audit trail, it is suggested that ERDF resources are kept in a separate bank account.

The retention of supporting documents for expenditure eligible to be co-financed by the Structural Funds is required in order to evidence that the funding conditions at the various levels, including that of the final recipient, have been observed and as to enable the auditors to check that all of the required information is appropriately collated and stored.

It should be noted that the Guidance Document on Management Verifications states that evidence of expenditure in the form of receipted invoices and proof of payment by final recipients / Urban projects is only required as part of the audit trail where the Equity, Loan or Guarantee to the final recipient is conditional on it incurring expenditure on particular goods or services. Within these limits, it is important for UDFs to maintain adequate audit trails in relation to Urban Projects. Thus UDFs will need to include required audit detail and control systems for Urban Projects in all Investment Agreements. Urban Projects will also need to maintain full and accurate accounts and documentary evidence for Urban Projects expenditure eligible for OP funding on an open book basis, possibly including, where necessary receipts, invoices and evidence of expenditure approvals.

The UDF will need to keep up-to-date records of the identity and location of bodies holding Urban Project details. Where investee schemes are carried out through Special Purpose Vehicles or units and those vehicles or units cease to exist, the UDF must ensure that it acquires any records or documents held by the vehicle or unit and retains them in accordance with the Level II Funding Agreement requirements.

It is possible that Urban Projects receiving financial support from the UDF include components that would not be eligible for Structural Funds. In those cases, a clear audit trail distinguishing expenditure eligible under the Structural Funds regulations from ineligible expenditure must be established. The UDF will need to maintain a separate accounting system or use a separate accounting code for co-financed expenditure down to the level of individual investments made into Urban Projects.

UDFs will also need to maintain records capturing all aspects of the decisions to fund Urban Projects. This should include documents illustrating how the UDF formed an audit opinion of each Urban Project supported and how the key terms and conditions of the Investment Agreement were determined.

Urban Projects should be monitored regularly through site visits, verification of expenditure claims and regular Progress Reports. It is recommended that the frequency of Progress Reports and the content required in the reports are specified by the UDF in the Investment Agreement.

Accounting Records and Treasury Management

The UDF must ensure that all records are kept accurately and faithfully. The UDF and statutory auditors will require the UDF to demonstrate the trail of information from initial data entries through to the production of the financial statements and where applicable statutory accounts. The accounting trail needs to include information to allow the auditors to produce an appropriate audit opinion.

The auditors will also be looking to see that if a UDF is set up within an existing Financial Institution as a separate block of finance records are kept to distinguish the resources invested through the UDF from those initially available in the institution. Accounts should also be maintained with accounting codes which mark out each contribution from the OP including priority axis. It is recommended that the UDF's accounting department should reconcile accounting dates, total assets at year end, liabilities, revenues and expenses attributable to the UDF on a regular basis (e.g. quarterly).

In line with Commission and local legislation the UDF must make sure it has the correct number of bank accounts with suitably credited banks (see Section 3 of this document). The UDF should have its own Treasury Management policy which auditors will check is being followed and is fit for the purpose of sound financial management.

Final recipients and eligible expenditures

The MA and Commission will carry out spot checks on the UDF to test whether the UDF suitably monitors the use of OP resources. The auditors will be looking at whether the UDF has systems in place to identify eligible expenditure and whether the expenditures taking place satisfies eligibility requirements.

At the final recipient level the UDF and the auditor should both investigate whether the amounts invested and returned, gains made and defaults reported have actually occurred and are correctly calculated. The auditor will also be seeking to clarify whether the resources have ultimately been used for the agreed purpose.

With respect to sound financial management, the Commission auditors will also want to be aware of some other issues such as:

- Contribution to the final recipients' performance (e.g. jobs created/maintained, new products or services developed);
- How current forecasts compare with original Plans, and reasons for any significant discrepancies;
- Whether activities of the final recipient will continue in the future to be consistent with the activities foreseen the Investment Agreement.

Recycling and allocation and use of interest and returns

The auditors will test that the UDF is complying with the terms of the Operational Agreement in respect of the recycling of interest and returns from investment. This should be evident in a clear audit trail as set out in Section 3.4 above.

Winding up and exit policy

Commission regulations require that winding up provisions and exit policies for a UDF are included in the applicable Level II Funding Agreement. Auditors will wish to provide assurance that, when necessary, the UDF and Urban Projects are complying with the terms laid down between the HF or MA and the UDF. To extend that final recipients / Urban Projects are required to assist the UDF in this process, it is recommended that this is included in the applicable Investment Agreement (as set out in Section 3.5 above).

State Aid regulations

State Aid rules must be strictly adhered to by the Member States and the MA which will be assisted in this by the HF where appropriate. As such is it important for the HF and UDF to be fully aware those specially agreed provisions relating to the setup of JESSICA Operations within the jurisdiction, over and above generally applicable State Aid regulations, for example, those prescribed in an approved State Aid notification.

4.3.7 Accepted Documentation

As referred to in Article 90 of the General Regulation accepted financial and operational documentation includes:

- Original documents;
- Photocopies of original documents;
- Microfiches of original documents;
- Electronic version of original documents;
- Documents existing in electronic version only.

It should be noted, however, that copies of originals can only be accepted in versions certified to be in conformity with the original.

It is the responsibility of the MA to ensure that supporting documents are kept for three years after the partial or final closure of the OP (Article 90 of the General Regulation). UDFs will need to agree with the MAs/HFs on where to archive the documents (e.g. with the UDF, HF or MA). Regulations also stipulate that all documents demonstrating compliance with conditions attached to individual investments be kept, including where necessary proof of purchase of certain goods and services, or other effective realisation of the investments for which Structural Fund support has been received.

4.3.8 General Audit Action, Timeline and Personnel

Sections 4 and 5 of DG REGIO's Common Audit Framework provide guidance to auditors on the planning and fieldwork stages of the audit process. The framework provides information on how the auditor should consider the inherent risks of UDF operations, compile and analyse audit evidence, and use sample transaction testing to form audit opinions. It is recommended that managers review this guidance to ensure that their own internal control processes are in a position to meet the reasonable requests of auditors performing UDF audits.

The MA will inform the UDF as to when the UDF will need to submit an annual financial statement (see reporting section). The UDF will need to consider the date by which their audits of the Urban Projects will need to be complete and therefore should include details in the Investment Agreement around when these will be carried out. The UDF will also need to set dates for Urban Projects providing them with progress reports and current financials.

4.4 Reporting

Reporting is the element of the monitoring process that provides HFs and MAs with the information they need to track programme and Urban Project progress and put in place the audit trail of evidence that will be used by the Audit and Certifying Authorities, and the Commission Audit, to certify that UDF investment resources have been made in accordance with the OP and regulations.

The reporting process from the UDF and Urban Projects should be designed to support the reporting obligations of the MA to the Commission while providing a mechanism for monitoring the progress of Urban Projects. Reporting must be considered at three levels:

- From Urban Project to the UDF;
- From the UDF to the HF (if in place);
- From the HF to the MA.

UDFs will need to agree the reporting procedures that must be applied as a part of their overall monitoring and audit obligations with the applicable Level II Funding Agreement. Where possible, standard reporting templates should be used and prescribed within applicable Level I Funding Agreements and Level II Funding Agreements.

The timing of reporting deadlines should be aligned with the HF/ MA reporting deadlines to the Commission. Managers of Structural Fund programmes are typically required to report the progress of project execution two to three times a year, usually within one month of the end of each reporting period. This may serve as a guide for UDFs to agree with HFs/MAs timetable detailing the reporting milestones (e.g. semi-annually or annually).

As a sample case, the chart below outlines a likely distribution of reporting requirements associated to a JESSICA Operation, which may apply to UDFs as well as other delivery bodies. Reports for various periods (at programme inception, half yearly, annual and at programme conclusion) are included to provide an indicative reporting timeline.

Indicative Chart of Reporting Requirements

	At Programme Inception	Half Year (or more frequent)	Annually	At Programme Conclusion
Urban Projects		Project Monitoring Report (submitted to UDF)	Annual Project Monitoring Report (submitted to UDF)	Final Project Implementation Report (submitted to UDF)
		Interim financial Statements (where required)	Summary financial statements (submitted to the UDF with Annual Project Monitoring Report	Final financial statements (submitted to the UDF with Annual Project Monitoring Report
			Statutory Financial Statements certified by external audit firm (submitted to Government and UDF)	
UDF		UDF Monitoring Report (submitted to the HF or MA)	Annual UDF Monitoring Report (submitted to HF or MA)	Final UDF Implementation Report (submitted to HF or MA)
		Interim financial Statements (where required)	Summary financial statements (submitted to the HF or MA with Annual UDF Monitoring Report)	Final financial statements (submitted to the HR or MA with the Final UDF Implementation Report)
			Statutory Financial Statements certified by external audit firm (submitted to Government and MF or MA)	
Holding Fund (if used)		Progress Reports based on reports from the UDF (submitted to the MA)	Annual Progress Report based on reports from the UDF (submitted to the MA)	Final HF Implementation Report (submitted to MA)
		Interim financial Statements (where required)	Summary financial statements (submitted to the MA with Annual Progress Report)	Final financial statements (submitted to MA with Final HF Implementation Report)
			Statutory Financial Statements certified by external audit firm (submitted to Government and MA)	
Managing Authority		Irregularities reporting, as needed	Annual implementation report (submitted to the Commission)	Final implementation Report (submitted to the Commission); includes final payment claim, control report and auditors statement, final due date 31 March 2017
			Annual Financial Control Report (submitted to the Commission)	
Audit Authority	Compliance Assessment and Annual Controls Certification Report		Supports the MA with the Annual Control Report	

The following sections provide further detail on the reports included here.

4.4.1 Operational Reporting

All the reports highlighted in grey – the interim and annual Urban Project Monitoring Reports, UDF Monitoring Reports, HF Progress Reports and MA Annual Implementation Report – are focused on **Operational Reporting**, which outlines the outcomes of monitoring activities. The purpose of these reports is to document the progress of Urban Projects, the management effectiveness of the delivery bodies and the controls in place. The Operational Reports likely to be required of UDFs are:

- UDF Monitoring Reports – submitted to the HF/MA on a six monthly basis or at other more frequent intervals if required by the HF or MA;

- Annual UDF Implementation Reports – submitted to the HF/MA on an annual basis.

UDFs will need to work with HFs/MAs to agree the format for each of these reports. The Template Monitoring Report included in Annex II of COCOF Note 3 and the EIB templates included in Section 4.1 on monitoring indicate the type of information likely to be required from the UDFs for Operational Reporting. Irregularities reporting is a key component of Operational reporting, and is discussed in further detail in Section 5.3.

4.4.2 Financial Reporting

All the reports highlighted in green are focused on **Financial Reporting**. The types of financial reports likely to be required of UDFs are:

- Interim Financial Statements – submitted together with the UDF Monitoring Reports to the HF/MA on a six monthly basis, or other more frequent interval if so required;

- Statutory or Audited Financial Statements – submitted to national authorities and the HF/MA on an annual basis.

For the Interim Financial Statements, UDFs will need to send statements of expenditure and payment requests together with interim Operational Reports (e.g. the UDF Monitoring Report), depending on what has been agreed with the HF/MA. The UDF will need to be prepared to provide additional information related to certain expenditures if requested by the HF/MA. It is recommended that the UDF's accounting department should reconcile accounting dates, total assets at year end, liabilities, revenues and expenses attributable to the UDF on a regular basis to support the interim financial statement requirements and to provide regular oversight for Urban Project and programme expenditure. Where Statutory Financial Statements are required, the UDF will need to have them certified by an external audit firm prior to submission according to national guidelines.

5. HORIZONTAL THEMES

5.1 Overview

This section covers a number of topics that impact across the lifecycle of the UDF, which as such do not fit within the implementation phasing of chapters 1 to 4.

In addition to the themes outlined below, it is helpful to ensure that State Aid provisions are continually assessed throughout the lifecycle of the UDF. Chapter 1.5 provides an analysis of the impact of State Aid provisions on the set up and delivery of UDFs, including their operation and investment activities.

5.2 Costs and Fees

Article 43(4) of the Implementing Regulation, allows for Urban Development Funds to be reimbursed or compensated for the activities required to manage OP resources and facilitate their investment in eligible Urban Projects. It specifies that the Management Costs and Management Fees are not to exceed 3% of the capital contributed from the OP to the UDF, unless a higher percentage proves necessary following a competitive tender.

Eligible management cost and fee expenditure includes the preparation of investment decisions and the subsequent monitoring and follow-up of investments (e.g. technical preparatory studies, audit, legal expertise, etc.). These however cannot include costs which are directly attributable to the preparation and/or implementation of individual schemes by final recipients, such as the costs of obtaining planning consent detailed design studies or project management expenses which are to be considered as part of the cost of the investment.

It is recommended that UDFs provide adequate details of expected (and eligible) Management Costs and Management Fees, including calculation methods, in their Level II Funding Agreements. They are also required to keep appropriate evidence to demonstrate that Management Costs and Management Fees correspond to sound and efficient management and financial principles.

The remainder of this section outlines the Eligible Expenditure and fees in the context of existing regulations as well as recommended procedures for calculation, and fee payment.

5.2.1 Set Up Costs

COCOF Note 3 refers to the recovery of costs and fees incurred for the preparatory work required to set up a UDF, clarifying that these are recoverable, but can be claimed only after the signature of a Level II Funding Agreement. The cost of the following set up activities may be considered allowable set up costs, but these will need to be confirmed with the HF/MA:

- The costs of establishing the UDF legal entity (including legal fees incurred);
- The costs of establishing the processes specific to the UDF (to potentially include the development of Level I Funding Agreements and Level II Funding Agreements).

To accommodate the costs that occur for UDF set up, regulations allow for the total Management Costs and Management Fees in the early years of operation to exceed the average annual spending limit set out in Article 43(4) of the Implementing Regulation. Paragraph 2.6.7 and 2.6.8 of COCOF Note 3 states however that spending over the limit for initial years is only allowed if the average yearly limit on Management Costs and Management Fees is not exceeded over the period of operation of the financial instrument during the OP period.

5.2.2 Management Costs and Management Fees

Paragraph 2.6.1 of COCOF Note 3 clarifies that Management Costs are to be considered as the cost of items reimbursed against evidence of expenditure, and Management Fees as an agreed price or compensation for services rendered. Eligible expenditure for Financial Engineering Instruments, can be classified as fixed costs and fees, activity-related fees, and performance based fees.

Fixed costs

Eligible fixed costs are comprised of expenses directly linked to the management and investment of contributions from OPs to the UDF including items such as staff costs (including travel and subsistence expenses), office costs, equipment, IT systems, consumables and supplies. Overheads of Financial Institutions acting as a UDF are also considered eligible, as long as the overheads are based on actual costs and are allocated pro rata to the UDF operations according to a duly justified fair and equitable method.

Activity costs

Eligible activity costs are defined broadly as costs incurred to carry out activities such as selection and tendering procedures, controls, monitoring and reporting, consultancy, information and publicity. The regulations do not provide deeper detail on eligible activity; it may be helpful to distinguish between *Fund Management*, *Investment Management, and Accounting and Programme Administration* activities.

Fund Management activities are focused on the overall stewardship and financial management of the UDF and could include:

- Management for overall UDF operations;
- Development of the Investment Strategy;
- Fund development planning;
- Investment review and recommendations;
- Operational oversight of investments;
- Raising Private Sector Investment;
- Governance and reporting;
- Treasury Management.

Investment Management activities are focused on the management of the investment portfolio, including:

- Managing fund operational and back office activities;
- Sourcing, evaluating and "working up" transactions;
- Producing a detailed proposals on investments and proposing them to the governing bodies; and
- Monitoring investments and fund performance.

The Investment Management function would also typically include the activities below, which the UDF may choose to subcontract:

- Conduct Specific State Aid assessments for investing in final recipients following Urban Project selection by the Investment Manager;
- Provide assurance to the management board that specific investments made by the Fund are in accordance with the Investment Strategy.

Accounting and Programme Administration activities cover accounting, back office and programme management services, as shown below:

- Accounting for the UDF;
- Establishing internal control systems;
- UDF compliance against the Level II Funding Agreements and EU regulations;
- Reporting expenditure against the business plan and HF/MA reporting requirements;
- ERDF monitoring, management and liaison with auditors.

The above activities for which a UDF may charge costs and fees will normally be agreed with the HF/MA in the Level II Funding Agreement.

Performance-based fees

UDFs are encouraged to utilise performance based fees[41] and to include details of such remuneration structures in their Level II Funding Agreements. This could include formulae which take into account benchmarks for effective investments, and should be linked to the quality of investments effectively made, possibly linked to their contribution to the achievement of the strategic objectives of the OP and the UDF, as well as the value of the resources returned from investments.

[41] Where a UDF is providing State Aid within its operations, performance based fees are an essential component of the assessment undertaken by the Commission to ensure only the minimum level of aid is provided and this aid is not providing an investor, fund manager or project with an above level of market return.

The following is a list of potential performance based fees that could be used by a UDF. Criteria for these fees will need to be carefully defined in the Operational Agreement so that they appropriately incentivise successful investment against OP and UDF priorities.

- Investment Development Fees provided when investments are successfully placed;
- Fees provided as a proportion of raised as private contribution, where foreseen;
- Fee for successful return on investments provided for Income Receipts and Capital Receipts above set limits.

Article 43 (4) of the General Regulation specifies that the Management Costs and Management Fees are not to exceed a set percentage of the capital contributed from the OP to the UDF. During the period of the OP, the costs and fees will need to be calculated on the basis of the capital effectively contributed, not the amounts committed and from no other source (as referred to in Section 2.6.9 of COCOF Note 3).

Interest and other gains from Urban Project investments can be used to support Management Cost and Fees, however as highlighted in Chapter 3.4, resources paid back (e.g. principal of a loan) shall be re-used for further investments through UDFs in line with the OP. The Gains from Urban Project investments can be used, up to the amounts necessary, for reimbursement of UDF management costs, preferential remuneration of investors under MEIP or further investments through FEI in line with OP.

Charging costs and fees (final recipients/ Urban Projects)

It is important to note that some of the activity fees focused on the arrangement of investments such as legal and accounting advisers' fees and monitoring fees) may be charged to final recipients (Urban Project contracted to receive repayable investments) by the UDF. These arrangement fees or any portion thereof, may or may not overlap with the Management Costs or Fees of the fund. These arrangement fees may be claimed as eligible expenditure to the extent that they constitute a part of Management Costs or Fees, but in that case they cannot be charged by the UDF to the Final Recipient.

For clarity, Section 2.6.17 of COCOF Note 3 states that *“if the Financial Engineering Instrument charges the final recipients with such arrangement or other fees, the amount of these fees is to be deducted from eligible expenditure claimed from the Structural Funds under Article 78(6) (d) of the General Regulation. Therefore, at closure, the amount charged by the Financial Engineering Instrument to final recipients, which has been taken into account as eligible expenditure as part of the Management Costs under Article 78(6) (d), should not be part of the eligible expenditure of this instrument under Article 78(6) (a), (b), (c) and (e) of the General Regulation”.* (Further guidance on the treatment of these costs and avoiding duplication of expenditure within the statement of expenditure is included in 2.6.15 and 2.6.16 of the COCOF Note 3).

5.2.3 Payment of Fees

The schedule for paying Management Costs and Management Fees should be defined in the Level II Funding Agreement. As an example, one of the structures currently proposed by the EIB outlines a payment structure in calls for Expressions of Interest to selected UDFs which could be used as a base for developing a schedule of payments. It proposes the payment structure, outlined in the box below[42]:

UDF Management Fee Structure
proposed by a JESSICA Holding Fund

1) During the period of the Operational Programme (up until [date]) the fee shall be paid quarterly or semi-annually, in advance unless otherwise agreed in an Level II Funding Agreement;

2) In 'initial' years of the programme (from [date] to [date]), the UDF shall be entitled to receive a maximum management fee, on an annual average, of 3% of the capital contributed from the MA to the UDF from the Operational Programme;

3) During the final two years of the programme ([date] to [date]) the UDF shall be entitled to receive a management fee of up to a maximum amount of, on an annual average, 2% of the capital contributed from the MA to the UDF;

4) After the conclusion of the Operational Programme on [date], or any other specific date agreed with the Holding Fund/MA, the UDF will be entitled to receive a management fee paid from monies returned into the UDF from investments in Urban Projects. The UDF will need to propose for the management fee and shall be up to an amount calculated as an annual percentage of the amounts repaid to the UDF. (The remuneration structure proposed by the applicant for this period shall be constructed to that the UDF operates with a sound and performance-based incentive structure. The UDF shall bear the risks when Income Receipts and Capital Receipts are not sufficient to pay for the management fee and the Holding Fund/MA shall not be obliged to cover any shortfall in these fees from [date] and beyond.) Management fees shall not be calculated on the amounts due by any Urban Project to a UDF; they need to be calculated based on what has been received.

5) The UDF bears the risk of a potential reduction in Management Costs and Management Fees in cases where it does not meet investment targets. For instance, if the operational and financial agreements require that 50% of funds be allocated by [date] and less than 50% is allocated, a fee reduction may be applied in proportion to the shortfall of investments as compared to the target.

6) The amount equal to the management fee shall be each time debited by the UDF (when due) from the amounts held by the UDF. This should be detailed in the operating agreement.

The above example is illustrative how a fee structure may be designed for a UDF. In this case, higher fees are set for the initial years of the programme and the source of the fees shift from the OP resources to receipts upon the completion of the OP cycle. Managing Authorities and Holding Funds will have the opportunity to work with UDFs to define appropriate fee structures and fee payment deadlines given the nature of investment priorities and local constraints. These details will need to be included in the Level II Funding Agreement. Finally, UDFs will need to be prepared to submit annual statements of Management Costs and evidence of reconciliation, where applicable. (Section 3.1 provides an outline of Treasury Management practices appropriate to the collection of UDF Fund Manager fees).

5.3 Irregularities

All UDFs are 'economic operators' (as defined by Article 27 of the Implementing Regulation) as they take part in the implementation of OP resources and therefore need to be aware of the requirements of the regulations for detecting and reporting ERDF irregularities. Article 1(2) of Regulation 2988/95 defines an 'irregularity' as:

[42] Deloitte Research: Consultation with UDF Fund Managers

"any infringement of a provision of Community law resulting from an error or omission by an economic operator, which has, or would have, the effect of prejudicing the general budget of the Communities or budgets managed by them, either by reducing or losing revenue accruing from own resources collected directly on behalf of the communities, or by an unjustified item of expenditure"

It is important that UDFs recognise that the regulation's definition of irregularities specifies that any infringement or omission that has, or would have, an impact on the Fund budgets causes an irregularity to occur. It should be noted that, a loss of OP resources is not necessary for an irregularity to occur, as a system process or management issue within a UDF could also mean an irregularity exists under the regulations. In this context, UDF Fund Managers need to be aware of and make plans to mitigate two main types of irregularities:

- Financial irregularities – a financial error causes payment to be made that is not allowable under ERDF rules. A financial error may arise as a result of ineligible expenditure, inaccurate calculations or fraud.

- Non-financial irregularities – a failure to comply with ERDF Regulations during UDF operations that does not involve the loss of OP resources such as lack of compliance with publicity or equal opportunities rules.

5.3.1 Overview of General ERDF Irregularities

Before describing the detailed implications of the regulatory framework relevant to the handling of irregularities relevant to UDF operations, it is important to consider general conditions on how irregularities usually arise, irrespective of whether they occur under a grant/regime or within a JESSICA Operation:

Financial Irregularities

- Ineligible expenditures are included in the calculation of OP resources paid or approved to for payment;

- Incorrectly calculated claims for OP resources made by an Urban Project;

- Falsified or fraudulent claims for OP resources made by an Urban Project;

- Non-existent or incorrectly declared claims;

- Inadequate systems for the control and monitoring of OP resources awarded to Urban Projects;

- Lack of adequate supporting documentation to satisfy the Commission's audit processes.

Non-financial Irregularities

- Not delivering or failing to show evidence of the delivery of required outputs and objectives for invested OP resources;

- Accidentally incorrect or falsified administrative entries;

- Failure to implement required publicity or procurement processes;

- Failure of an Urban Project to comply with the terms and conditions of a contract to receive OP resources (such as a UDF Investment Agreement).

Irregularities for grant programmes are generally isolated to the expenditure of OP resources, arising from whether the grant was spent on eligible activities that are defined in the OPs. Section 4.1 on monitoring provides examples of typical issues that could lead to irregularities and examples from the European Anti-fraud office, which investigates ERDF irregularities. The European Anti-fraud office also publishes example closed cases of fraud to illustrate the nature of irregularities that take place[43].

MAs are responsible for ensuring that OP resources are directed to eligible activities and final recipients comply with EU rules. However, the process of managing financial instruments (Loans, Equity and Guarantees) and monitoring the progress of an investment to deliver not only economic outputs but also financial returns introduces additional responsibilities for the UDF Manager. Good practice for fund based investments (as defined by the Commission's principles of sound financial management) therefore presents an additional layer of compliance required by the UDF Fund Manager.

Due to the nature of Level I or II Funding Agreements, MAs or HFs normally delegate a substantial share of the responsibility for proper use of Funds to the UDFs. An example of this is the role played by the UDF in the selection of suitable investments OP objectives, in contrast to the grant regime, where MAs or its delegated agents typically would review each grant application by an Urban Project and determine if it is appropriate for it to receive OP resources. A UDF Manager therefore takes on a pivotal role in ensuring OP resources are invested in eligible Urban Projects expenditures and the associated risks of being in breach of the regulations.

Chain of responsibility for irregularities

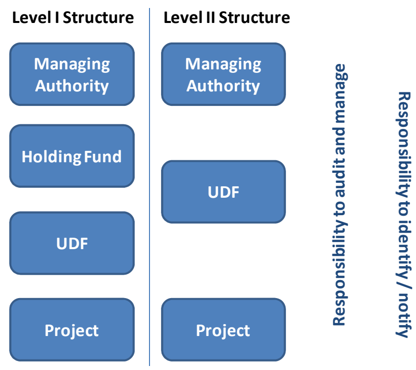
All stakeholders within a JESSICA Operation have a responsibility for the prevention, detection and resolution of irregularities, which can be summarised as:

- Undertaking actions with appropriate systems and controls to prevent the occurrence of irregularities;

- Undertaking auditing and monitoring of the actions undertaken to identify irregularities.

The following diagram outlines the flow of these responsibilities for the HF/MA, UDF and Urban Projects:

[43] OLAF web link - http://ec.europa.eu/anti_fraud/reports/anti-fraud_en.html



Section 3.3.1.3 of the Holding Fund Handbook provides detail on the responsibility for monitoring and correcting irregularities drawing from the Implementing Regulation and EU Regulation 846/2009. In summary it advises that:

1) MAs are responsible for collecting detail on irregularities with assistance from the HF where in place;

2) MAs or HFs are responsible for correcting irregularities and cooperate with UDFs to resolve issues;

3) MAs or HFs are responsible for estimating losses caused by irregularities and for sending requests for the recovery of sums wrongly paid; these requests are submitted to the UDFs who are in turn responsible for contacting the final recipient to obtain the reclaimed amount.

It is important for UDFs to review Section 3.3.1.3 of the Holding Fund Handbook to understand the type of information required by MAs or HFs where these are in place when monitoring and addressing irregularities.

A UDF therefore has the following operational task to fulfil:

- Managing Funds provided to it in conjunction with the terms of the Level II Funding Agreement;
- Selecting and making investments in Urban Projects that are compliant with the regulations;
- Monitoring the performance of Urban Projects to ensure potential irregularities are identified;
- Notifying the MAs or HFs of all breaches, or potential breaches of the regulations;
- Notifying the final recipient / Urban Project of breaches the UDF identifies and working with the Urban Project to resolve them;
- Assessing breaches that the UDF is notified of by the final recipient / Urban Project and similarly working with the final recipient / Urban Project to resolve them.

Illustrations of Potential Irregularities Specific to Financial Engineering Instruments

The following examples illustrate categories of irregularities that could arise within the operation of a UDF:

Financial Irregularities

- An Urban Project is incorrectly selected for investment as it does not contain sufficient eligible expenditure as defined by the local OP;
- An Urban Project receives an investment that is not in accordance with EU regulations, for example it contravenes State Aid regulations;
- Urban Project performance or outcomes are not in line with what was contracted between the UDF and the final recipient / Urban Project in the Investment Agreement.

Non-financial Irregularities

- There is a systemic or control failure, or management deficiency in a UDF that presents the risk of irregularity occurring. There a range of possible causes, including not following EU regulations on procurement, publicity, monitoring and reporting.
- UDF undertakes actions that contravene its Operational Agreement with the MA or HF, such as failing to meet reporting requirements or not providing levels of co-investment;
- MA or HF enforces contractual terms on the UDF that are in contradiction with EU regulations.

5.3.2 Approach to Resolving Irregularities

The following section outlines the steps that the UDF must undertake as part of the process of resolving irregularities. Readers are encouraged to also review Section 2.2 ('Investment Decision Making') which contains important guidelines on the UDF's relationship with Urban Projects.

Step 1: Process of identification

As outlined earlier in this chapter, the UDF should undertake a regular monitoring of Urban Projects to ensure that as Urban Projects progress they remain compliant with the terms of the UDF's Investment Agreements, which will incorporate financial and non-financial obligations arising from the ERDF Regulations for the use of OP resources. It is expected that irregularities could potentially be identified by a UDF during one or more the following events:

- When a UDF reviews a claim for payment by an Urban Project under an Investment Agreement;
- During a monitoring review or visit carried out by the UDF to verify the performance of an Urban Project;
- During an audit visit carried out by the MAs or HFs as part of reviewing general UDF adherence to its Operational Agreement and its compliance with ERDF Regulations;

- During audit visits by representatives of the Commission, European Court of Auditors and any other Commission or nationally empowered body;

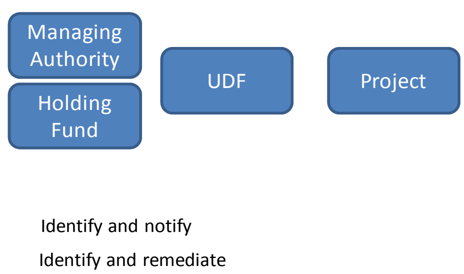
- As a result of an Urban Project notifying either the UDF, HF or MA of a financial or non-financial breach of the rules;

- As a result of a third party, such as private company or individual, notifying the MA of suspicions that an irregularity may exist.

Step 2: Process of notification

It is recommended that a formal notification process is established between the HF/MA, UDF and Urban Projects. The process should ideally be established by the MA as a protocol for the negotiation of Level I or II Funding Agreements and be adopted by the HF and UDF as part of relevant Operating and Investment Agreements. In geographies where the MA has not established this protocol, UDFs should agree basic notification requirements with the MA as part of agreeing its appointment.

The diagram below helps outline how the UDF is responsible for detecting, reporting and remediating irregularities for the HF/MA and also monitoring the actions of Urban Projects to detect irregularities and determine the appropriate actions for an Urban Project to take to correct an irregularity.



The process of notification should incorporate the following steps:

- Provision of written notification by the UDF to the HF/MA that an irregularity has occurred or is likely to occur (this step may not take place if the irregularity is identified by the MA or HF);

- Written confirmation from the HF/MA to the UDF that an irregularity has been identified and action is required;

- Meeting arranged between the HF/MA and UDF to review the irregularity event and remedial actions to take (it may also be appropriate for representatives of the Urban Project/ final beneficiary to also attend this meeting for the purposes of understanding its role in the remediation of the irregularity);

- Written confirmation from the MA or HF as to whether the irregularity can be remedied (or potential irregularity avoided in the cases of early detection where the MA deems that an irregularity has yet to take place) and any remedial actions required;

- Appeal or arbitration process for the UDF or Urban Project to formally challenge the MA or HFs interpretation of the irregularity event and prescribed remedial actions.

Step 3: Remedial action ("Financial Corrections")

The remedial action required to address the breach is dependent on the nature of the breach and the judgement of the MA overseeing the OP. These actions are covered in Article 98 of the General Regulation (supplemented by Articles 27 to 36 of the Implementing Regulation), which places the responsibility for determining appropriate action with the MA and states that a correction aims to recover the original ERDF resources.

In summary the regulation requires:

- The MA to investigate any irregularities, acting on evidence that one may have taken place.

- The MA to make a correction necessary to correct an individual irregularity (such as withholding further payments of OP resources or seeking repayment of OP resources already paid) and, in the instance of a systemic irregularity, further investigate and ensure appropriate management and systems processes are improved before further OP resources are paid.

- The MA must take into account the severity of the irregularity and its impact on OP resources when determining if the irregularity should be reported to the Commission and deciding on the appropriate corrections to be enforced. For example, irregularities with a small monetary value, arising from a minor mistake may only require withholding future payments of OP resources. However, a wilful action by a beneficiary that causes an overpayment to be made may be more appropriately dealt with by seeking a repayment from the beneficiary.

The regulations do not specify any additional or special conditions to be applied to resources directed through Financial Engineering Instruments, such as UDFs. So the general principles of the regulations have to be applied by the MA to irregularities arising out of UDF operations or investments.

By reviewing the type of actions normally undertaken by the Commission or MAs after the identification of an irregularity, the following acts of correction are typically expected to be undertaken, each of which have particular challenges for a UDF:

Possible Correction	**UDF impact**	**Suggested Response**
All future payments of ERDF by the HF/MA are withheld from the UDF	The UDF would be unlikely to make any further investments into Urban Projects, including those Urban Projects where only part of Loan, Equity or Guarantee investment has been made to date. The UDF could therefore be in a position of breaching future Investment Agreements it is	A UDF should include clauses within its Investment Agreements with Urban Projects that allows it to cancel further investments it is subject to this type of correction. To mitigate the impact of corrections arising due to a systemic failure by the UDF, professional indemnity insurance policies should be considered by

	committed to.	the UDF operator.
Future payments from the MA to the UDF reflect a deduction relating to the irregularity	The impact would result in a reduction of 'investment capital' for the UDF to place with future Urban Projects. Practically, this might compromise the UDF's ability to undertake any further investment, because, assuming the UDF is considering investment in other Urban Projects, those new Urban Projects would not be fully funded from the OP resources claim made in their regard. The Urban Project causing the irregularity, would therefore not be directly penalised by the withholding of future resources by the HF/MA, unless the UDF takes actions itself to recover its investment. It is also possible that the UDF received all its allocated Resources in advance and therefore no future payments are expected.	The UDF includes 'claw-back' clauses within its Investment Agreements with Urban Projects to ensure that the impact of corrections is largely impacted on those Urban Projects where the irregularities arose. To protect against corrections arising out of UDF operator errors, professional indemnity insurances should be considered.
Repayment of the ERDF is requested	As a Fund Manager, a UDF operator is unlikely to have access to the resources required to repay ERDF to a MA without first withdrawing it from the Urban Project. This will be a very challenging issue for a UDF as the nature of its investments will be long term typically needing to mature before value can be extracted. However, this is likely to be the most 'commercially fair' response to the irregularity as it directly attributes the correction to the Urban Project causing the irregularity.	Reviewing other similar types of investment resources, market options include: • Enforce an early repayment clause with an Urban Project agreement that can be activated if the UDF needs to recover its investment resources to repay OP resources to the HF/MA; • Sell the Urban Project investment to a third party and thereby raise resources which can be repaid to the HF/MA; • Raise finance secured against other Urban Project investments, which provides resources that are repaid to the HF/MA.
Legal proceedings commenced to	Should a MA deem that the irregularity is severe (for example in the case of wilful fraud being	The handbook does not seek to provide any guidance on how UDFs should commence

forcibly recover ERDF	committed) legal proceedings could be started between the HF/MA and the UDF. Assuming the UDF is not at fault, it would in turn be expected to commence similar proceedings with the Urban Project who is deemed to be in breach of the ERDF rules. This 'chain of liability' has been outlined in detail in Section 2.1.2 (Level II Funding Agreements)	proceeding against its Urban Project investment. However, it is suggested that the UDF ensures all its Investment Agreements with Urban Projects include clauses where the Urban Project acknowledges its responsibility to comply with the ERDF rules that apply to the UDF, as a condition of receiving UDF investment resources.

Further implications on early exit from investments ("Recoveries")

As outlined in step 3 above, recoveries present a set of unique issues for UDFs, which do not arise through the grant regime. Typically, grant 'offer letters' (the contract between the MA and beneficiary of OP resources) include a 'claw-back' clause which compels the beneficiary to repay the grant if the Urban Project is found to be in breach of EU regulations or the Urban Project does not deliver the economic impacts required by the OP (which provides the rationale for using OP resources to support the Urban Project).

An important part of the appraisal process for awarding grants is identification of a suitable 'Accountable Body'. The Accountable Body is effectively the guarantor that is called on to provide money for the recoveries in the instance that the grant cannot be clawed back from the Urban Project directly. Examples of Accountable bodies include:

- Security from a company that is related to the Urban Project receiving the grant. A common example of this would be the parent company of a subsidiary organisation delivering an ERDF supported Urban Project. This Parent company would have to be assessed by the UDF as having a strong financial position which would enable it to repay all OP resources in the event of a major issue arising on the Urban Project ; or

- Local public sector agency, which has a vested interest in the Urban Project. This is a common approach in many countries, where municipalities or councils agree to provide resources for recoveries if the Urban Project encounters an issue. It is usually an attractive position to assume for the local public sector agency, as they secure the benefits of ERDF investment in their area, with the likelihood that no cash commitments have to defray if the Urban Project is properly delivered.

Therefore, the treatment of recoveries for UDFs will require identification of a suitable organisation to act as 'Accountable Body' for the UDF investments at the point an Investment Agreement is being negotiated between the UDF and Urban Project. There are two areas within the JESSICA Operation that require further consideration, each of which should be properly reflected in the relevant contractual agreements:

- Level II Funding Agreement – an Accountable Body for the resources provided to the UDF by either the MA or the HF. This could be for instance a financial intermediary acting as UDF Fund Manager (in the case of a UDF set up as 'separate block of finance' within an existing institution) or a major public sector authority in the local area, possibly in the case of a UDF set up as a 'separate legal entity' with public sector involvement;

- Urban Project Investment Agreements – an Accountable Body for resources provided to Urban Projects by the UDF. These could be public or private organisations related to the Urban Project and willing to assume 'guarantor status', similar to the 'Urban Project grant' accountable status outlined above.

5.3.3 Reporting and Recording Irregularities

The responsibilities for reporting and recording irregularities are set out in Article 28 of the Implementing Regulation. MS must notify the Commission within two months of the quarter end of any irregularities arising, including details on the nature, scale and impact of the issue. There are certain exemptions applicable to reporting irregularities to the Commission. These are in the following cases:

- Failure to execute due to the bankruptcy of a beneficiary (note that in JESSICA Operations the beneficiary is the Financial Engineering Instrument);

- Cases which are notified voluntarily by the beneficiary;

- Cases which have been corrected before inclusion in a statement of expenditure.

In addition, Article 36 of the Implementing Regulation allows irregularities under €10,000 to be exempted from this reporting process, but in all cases where a fraud[44] is suspected, regardless of the monetary value of the suspected fraud, must be reported to the Commission and to OLAF, the European Audit Office. Article 30 requires follow up reporting during subsequent period of reporting on the progress of investigation of all previous Article 28 notifications.

This process affects UDFs in the following manner:

- UDFs have an obligation to notify the MA or HF if an irregularity is identified or suspected;

- UDFs should work with either the MA or HF to fully investigate the irregularity and then correct it;

- UDFs must ensure that all its investments are undertaken on terms that facilitate monitoring, audit and investigation of an Urban Project if necessary.

Article 28 of the Implementing Regulation outlines the reporting requirements of MAs and Article 36 of the same regulation explains the reporting exemptions. It should be noted that these are reporting obligations for the MA not the UDF. However, the UDF may be obligated by the terms of its contracts with the MA or HF to mirror such reporting. This should require the reporting of irregularities to the OLAF where the irregularity is greater than €10,000 or involve fraud of any value.

[44] Fraud is defined in the COCOF 09/0003/00 "Information Note on Fraud Indicators for ERDF, ESF and CF

5.4 Publicity

For any OP the MA is required to produce a communication plan approved by the European Commission. The UDFs should refer to these communications plan when developing their publicity plans and highlighting the added value of Financial Engineering Instrument for Urban Development Operations for OP objectives. It is recommended that the applicable Level II Funding Agreement include the publicity plans and requirements for the UDF and that these are reflected as necessary in Investment Agreements with final recipients/ projects. Within these documents, the publicity protocol should be agreed, including how any press or public announcements should be made and approved.

As stated in the Implementing Regulation on publicity, UDFs are obliged to *"publish information and publicity in accordance with the Commission Structural Funds regulations (including the acknowledgement of the Bank funding and identification of any National Co-financing)".*

Publicity Requirements

UDFs are responsible for ensuring that certain publicity conditions are met (by themselves and Urban Projects) to inform the public about the OP assistance obtained from the UDF as beneficiary. The section below outlines the minimum publicity requirements.

1) The following information should be included on any information and publicity documents for beneficiaries, potential beneficiaries and the public:

    - The type and name of the operation;
    - The emblem of the European Union (see Implementing Regulation, Annex I);
    - Reference to the European Union;
    - Reference to the fund concerned;
    - The statement chosen by the MA (as mentioned previously);
    - Preferably the words "Investing in your future".

2) Small promotional objects should also include the above but do not need to include the reference to the ERDF or the statement from the MA.

3) If the operation has involved purchasing a physical object or financing infrastructure or construction and has cost at least EUR 500,000 then during the operation a billboard should be put up at the site. The billboard has to include the following information, which should take up at least 25% of the billboard:

    - The type and name of the Operation;
    - The emblem of the European Union (there are further rules regarding the use of the European Union emblem, see Implementing Regulation, Annex I);
    - Reference to the European Union;
    - Reference to the fund concerned;
    - The statement chosen by the MA (as mentioned previously);
    - Preferably the words "Investing in your future".

4) When the operation is complete a visible permanent plaque of significant size must be put up no later than six months after the operation has finished. The same information should be included on this plaque and should take up at least 25% of the plaque.

These basic requirements will need to be included in UDF publicity plans, which will also need to integrate the publicity requirements set by their MAs.

6. GLOSSARY

Word/Phrase	Description
Accountable Body	The guarantor for funding awarded who is responsible for the recovery of irregularly invested resources in the case that the funding cannot be clawed back from an Urban Project directly. An example of an Accountable Body would be a local authority/similar government agency, which has vested interests in an Urban Project but is not directly involved in its implementation.
Acquisition	An Acquisition is a corporate action in which an enterprise or individual buys some, of a target enterprise's ownership stakes in order to assume control of the target enterprise.
Annual Implementation Report	As defined in Article 67(1) of the General Regulation, submitted each year by 30 June by the Managing Authority to the Commission, describing activities performed, including Urban Projects approved and funding paid, on the implementation of the Operational Programme.
Annual Control Report	As defined in Article 62 (d)(1) of the General Regulation, submitted by the Audit Authority to the Commission each year by 31 December describing information on findings of audits carried out in accordance with the audit strategy of the operational programme and any reports of shortcomings found in the systems for the management and control of the programme.
Audit Authority (AA)	As defined in Article 59 of the General Regulation, the Audit Authority is a national, regional or local public authority or body, functionally independent of the Managing Authority and the Certifying Authority, designated by the Member State for each Operational Programme and responsible for verifying the effective functioning of the management and control system.
Auditing	Activities conducted to establish an adequate evidence trail exists and testing of the system of controls that generate that evidence. With regard to FEIs, the evidence trail should include reports on the use of OP resources and should verify adherence to the regulations in the use of those resources. A further aim of auditing is to ascertain the validity and reliability of financial information and assess the soundness of internal controls.
Beneficiary	The term Beneficiary as used in this document is defined in line with EU regulations and associated guidance. Article 2(4) of the General Regulation defines beneficiary as an operator, body or firm, whether public or private, responsible for initiating or initiating and

	implementing operations. More specifically, for operations falling within the scope of Article 44 of the General Regulation and Articles 43 to 46 of the Implementing Regulation, the beneficiary is any of the FEIs described in the first paragraph, points (a), (b) and (c) of Article 44 of the General Regulation, and where such operations are organised through a HF, to the extent that the HF is responsible for initiating or initiating and implementing the operation, the HF is the beneficiary.
Business Plan	For the purposes of this document, a Business Plan describes in detail how a FEI plans to achieve its goals, including from marketing, financial, non-financial impact and operational viewpoints. In other words, typically, it could illustrate current and proposed organisational structure, legal structure, financing and financial projections along with a market analysis as well as proposed investment focus, marketing approaches, fees, payment structures and operating procedures.
Capital Receipts	These are payments or distributions or other amounts received or to be received by the UDF or HF representing the repayment or return of all or part of the principal or capital element of any investment. See also Income Receipts. For the purposes of this document, this is typically the reimbursement by the Final Recipient of initial investment amounts paid by the UDF in line with an Investment Agreement. The reimbursement will potentially include the repayment of ERDF resources, national co-financing and co-investment that together formed the initial investment made by the UDF.
Certifying Authority	As defined in Article 59 of the General Regulation, a Certifying Authority is a national, regional or local public authority or body designated by the Member State to certify statements of expenditure and applications for payment before they are sent to the Commission.
Co-Investment	Resources to be used for Co-Investment could be either public or private in origin, can be introduced at HF, UDF or Urban Project level and are neither National Co-financing nor OP resources. Although the resources may be used for same or similar ends, Co-Investment activity will not need to abide by the same conditions that govern the use of OP resources.
COCOF Note 3	Refers to European Commission (Directorate-General Regional Policy) Guidance Note on Financial Engineering Instruments under Article 44 of the General Regulation (ref: COCOF_10-0014-04-EN)
Cohesion Fund	The Cohesion Fund is a structural instrument but not one of the Structural Funds. It has been in operation since 1994 to help Member States reduce economic and social disparities and to stabilise their economies. The Cohesion Fund (as defined by Article 2 Regulation 1084/2006) finances up to 85 % of eligible expenditure of Major Projects involving the environment and transport infrastructure. Eligible areas include the least prosperous Member States of the Union whose gross national income (GNI) per capita is below 90% of the EU-

	average.
Competitive Dialogue	A procedure for public procurement. Following the issue of an OJEU contract notice, interested parties first complete a Pre-Qualification Questionnaire to demonstrate they have the minimum capabilities for the services being procured. Further selection processes are then undertaken through dialogue and provision of additional information from potential bidders with the purpose of developing one or more solutions for required services. Based on this dialogue a short list of bidders are chosen to submit a final tender, from which a winning bid is selected.
Compliance Assessment	An initial check of control systems conducted by the Audit Authority (AA) to certify operations during the establishment of OP control processes and procedures.
Convergence Objective	One of three regional policy objectives of the EU Cohesion Policy, its aim is to promote growth-enhancing conditions and factors leading to real convergence for the least-developed Member States and regions.
Credit Risk Assessment	Credit Risk Assessment is a step in a risk management procedure related to the determination of the quantitative or qualitative value of the credit risk ("valuation") associated to an investment.
Cross Urban Project Testing	A statistical measure which could potentially be used as a part of a Key Control Framework (*see "Key Control Framework"*) which identifies Urban Projects with unusual characteristics by comparing information from different Urban Projects or programmes.
De Minimis aid Block Exemption	The De Minimis Regulation refers to small amounts of aid that the Commission considers will have no substantial effect on trade and competition between Member States. There is no requirement to notify De Minimis aid to the Commission. The maximum funding that any single recipient can receive is €200,000 (cash grant equivalent) over a 3 year fiscal period in order to be considered as being De Minimis aid.
De Minimis Regulation	Commission Regulation EC no 1998/2006 of 15 December 2006 on the application of Articles 87 and 88 of the Treaty to De Minimis aid - OJ L 379.28.12.2006.
Delivery Partners	Those organisations which play a role in the implementation of an Urban Project. This could include final recipients, Beneficiaries, Local Authorities, Architects, construction contractors, land owners, project managers, other consultants, etc.
Disbursement	Disbursement is an action undertaken by the UDF Fund Manager to release investment resources from the UDF into an Urban Project.
Disbursement	A type of UDF account which holds the initial payment of OP resources

Account	that the UDF receives from the MA or HF.
Eligible Expenditure	Payment made in accordance with EU regulations in relation to an Operation, including being in accordance with a Priority Axis of an Operational Programme. For the purposes of this report, this includes any payments from UDFs to final recipients made by the time of the partial or final closure of the Operational Programme.
Equity	In line with COCOF Note 3, equity is the (ordinary) share capital of a company. Typical features of equity capital include an entitlement to the profits of the enterprise, a proportionate share of the proceeds upon liquidation, subordination to creditors and a degree of control (through shareholder voting rights).
Equity investment	In line with COCOF Note 3, an Equity Investment refers to the Acquisition of an Equity participation (ownership) in an Urban Project or a UDF.
ERDF Regulations	Regulation (EC) No. 1080/2006 of the European Parliament and of the Council of 5 July 2006.
European Court of Auditors	The European Court of Auditors is the EU Institution established to carry out the audit of EU finances. As the external body having auditing rights over the Commission, it contributes to improving EU financial management and acts as the independent guardian of the financial interests of the citizens of the Union.
European Regional Development Fund	The European Regional Development Fund (ERDF) is a fund financed by European Union budgetary resources, set up in 1975 to stimulate economic development in the least prosperous regions of the EU. As one of the EU's Structural Funds, ERDF seeks to correct imbalances between regions across the EU and enhance economic and social cohesion.
European Social Fund	The European Social Fund (ESF) sets out to improve employment and job opportunities in the European Union and so help raise standards of living. It aims to help people fulfil their potential by giving them better skills and better job prospects.
Exit Strategy	For the purposes of this document, an Exit Strategy is a tool governing the process by which (1) a UDF disposes of investments made in its portfolio of final recipients, or (2) an HF/MA disposes of investments made in its portfolio of UDFs. In line with the indications provided by COCOF Note 3, an Exit Strategy governs the liquidation of holdings by a UDF or HF according to a plan to achieve maximum return, including trade sale, write-offs, repayment of preference shares/Loans, sale to another fund instrument, sale to a Financial Institution or other investor and/or sale

	by public offering (including Initial Public Offerings).
Expiry Date of Repayment Term	A Loan of a specific amount has a specified repayment schedule and thus a specified term to maturity. The expiry date refers to a date in the future upon which the borrower has to fulfil its last and final repayment obligation under the Loan.
Fair Rate of Return (FRR)	For the purposes of this document, the FRR represents the market rate of return reflecting the nature and risk attributes of an investment in an Urban Project. It can be defined for a specific investment through a public procurement process, benchmarking against similar investment opportunities or established by an independent expert. It can typically be used to assess if State Aid is being provided to recipients of public resources.
Final Recipient	For the purposes of this document, Urban Projects which are contracted to receive repayable investments (namely through equity participations, loans and/or guarantees and other forms of repayable investments implemented through similar transactions) from a UDF.
Financial Engineering Instrument (FEI)	For the purposes of this document, and in line with Article 44 of the General Regulation, this includes revolving instruments such as UDFs and HFs.
Financial Institution	An organisation that provides financial services for its clients or members. Broadly speaking financial institutions are deposit taking institutions that accept and manage deposits and make loans, including banks, building societies, credit unions, trust companies, and mortgage loan companies.
Financial Intermediary	An entity or person acting as a “middleman” in the supply and demand of financial products.
First Round Investments	Investments made (using OP resources) in final recipients. These investments should seek to deliver outputs and other outcomes outlined as performance indicators and/or targets of an Operational Programme (OP).
First Level Controls	Annual audit visits conducted by the Audit Authority (AA) on a subset of financial activities based on random statistical sampling to verify expenditure declared.
Follow-on Investments	Investments made using resources available to a UDF arising from Income and Capital Receipts received from its First Round Investments. These Follow-on Investments must be used in a manner consistent with Article 78(7) of the General Regulation, namely for the benefit of Urban Projects.
Follow Up Checks	Administrative checks made by the Certifying Authority to follow-up on the findings of First and Second Level Controls. (See “First Level

	Controls" and "Second Level Controls").
Funding Agreement	When FEIs are organised through HFs, this is either a written agreement concluded between (i) the duly mandated representative of a Member State or Managing Authority and a HF, or (ii) between the HF and a UDF. When FEIs are not organised through HFs, then this is a written agreement concluded a duly mandated representative of a Member State or Managing Authority and a UDF. The Funding Agreement should include the terms and conditions governing contributions to be made from Operational Programmes to the UDF or HF. (See also "Level I Funding Agreement" and "Level II Funding Agreement")
Funding Agreement Repayment	Resources repaid from either the UDF to the HF, from the HF to the Managing Authority or, in the case where no HF exists, repayment from the UDF to the Managing Authority.
Fund Manager	For the purposes of this document, the individual(s) or entity(ies) responsible for implementing the Investment Strategy and managing the portfolio of investments related to the HF or UDF (being equity funds, loans funds, guarantee funds), as the case may be, referred to under Article 44 of the General Regulation in accordance with the stated goals and provisions as set out in the Level II Funding Agreement.
Gains	For the purposes of this document, the returns on investment resulting from prudent treasury management of Idle Resources.
Gap Funding	For the purpose of this document, a regeneration initiative to attract private investment in potentially risky Urban Projects providing the minimum amount of public resources required to cover the difference between the cost of developing difficult projects and the market value of the project.
General Block Exemption Regulation (GBER)	Commission Regulation (EC) No 800/2008 of 6th August 2008. The GBER declares certain categories of aid compatible with the common market in application of Articles 87 and 88 of the Treaty. It also consolidates into one text and harmonises the rules previously existing in five separate regulations, and enlarges the categories of State Aid covered by the exemption.
General Regulation	The General Regulation of 11th July 2006 as amended is a piece of legislation "*laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and repealing Regulation (EC) No 1260/1999*".
Grant	Typically a non-repayable sum of money given by an organisation (most often a public sector entity) for a particular purpose that is defined by a set of eligibility criteria. For the purposes of this document, we refer to the definition provided in COCOF Note 3 where

	it states that "in general a grant will have the following features: • a contribution is made either to an action or project carried out by a grantee which falls primarily within the scope of the grantee's activities or direct to the grantee because its activities contribute to policy aims of the grantor, such action or project of the grantee normally being in the interest of the grantor; • the application for financing originates with the grantee, who submits a proposal for support for activities it is carrying out or plans to carry out; its proposal sets out the specifications for the action to be performed, which may be within a pre-set legal or other framework laid down in advance by the grantor; • ownership will normally remain with the grantee, although it is possible in some cases for the financial contribution to revert to the grantor at the end of an action; • the grant does not necessarily finance the total cost of the action; • the financial contribution of the grantor should not be in consideration of any product or service provided by the grantee to the grantor; • conditions can be attached to the grant awarded, but there is no direct and specific link between individual obligations on either side (grantor and grantee), although the grantor has the right to monitor technical implementation of the action and the use made of the funds granted; • the grant must not have the purpose or effect of producing a profit for the grantee; • the outcome of a grant award procedure is a grant agreement or a grant decision.
Guarantee	A guarantee is a commitment by a third party called the guarantor to pay the debt of a borrower when the latter cannot pay it himself. The guarantor is liable to cover any shortfall or default on the borrower's debt under the terms and conditions as stipulated in the agreement between the guarantor, the lender and/or the borrower. (Guarantees are also referred to in COCOF Note 3, paragraph 4.1)
Guarantee Notice	Commission notice (Article 1.2 and 1.3) on the application of Articles 87 and 88 of the Commission Treaty to State Aid in the form of Guarantees (Official Journal C 155 of 20.06.2008). This notice outlines criteria to categorise whether or not Structural Funds provided as Guarantees can be considered 'aid.'
Holding Fund (HF)	Financial instrument set up, according to Article 44 of the General Regulation, to invest in several venture capital funds, guarantee funds, loan funds, UDFs, funds or other incentive schemes providing loans, guarantees for repayable investments, or equivalent instruments, for energy efficiency and use of renewable energy in buildings, including in existing housing.
HF Fund Manager	A Fund Manager of a HF. The EIB is an example of a HF Fund Manager.

Idle Resources	Un-invested cash, held for a period of time by a UDF, before it is invested in an Urban Project or returned to UDF investors.
Implementing Regulation	Regulation 1828/2006 of December 2006 (as amended), which sets out rules for the implementation of the General Regulation (as amended).
In-kind Contribution	An In-kind Contribution is a non-cash input which can be given a cash value. Article 51(i) of the Implementing Regulation defines In-kind Contributions as contributions of a public or private beneficiary that can be considered as eligible expenditure if they fulfil the following conditions: a) they consist of the provision of land or real estate, equipment or raw materials, research or professional work or unpaid voluntary work; b) their value can be independently assessed and audited.
Income Receipts	These are payments to, distributions to or other receipts received by the relevant UDF or HF representing the payment of income to, or the earning of revenue by, the relevant UDF or HF in respect of its investments. These sums are over and above Capital Receipts and could include: _(i) interest (including capitalized interest and/or; _ (ii) dividends and/or; _ (iii) capital gains and/or; _ (iv) guarantee fees and/or premiums. For the purposes of this document, this is typically the payment by the Final Recipient of interest, dividends, premiums or other amounts due to the UDF that has invested in the Final Recipient by way of loans or equity, or equivalent instruments, or has provided a guarantee to the benefit of the Final Recipient.
Integrated Plan for Sustainable Urban Development (IPSUD)	An IPSUD comprises a system of interlinked plans comprised of a set of projects which seek to achieve specific aims impacting upon an urban area (or a collection of urban areas) and which seek to bring about a lasting improvement in the economic, physical, social and environmental conditions of a city or an area within the city. An IPSUD is a territorially focused document or set of documents that outlines an area's plan for the implementation of Urban Projects and programmes to support economic development. It is usually co-ordinated by the local public sector leadership body (Council or Municipality) and may also incorporate a degree of legislative power in respect of granting construction / development permits and preferred status for the expenditure of other public resources. *The Structural Funds regulations for the period 2007-2013 do not include a definition of, or specific requirements for, an "integrated plan for sustainable urban development". Consequently, these should be defined by Member States and managing authorities, taking account of Article 8 of Regulation (EC) No 1080/2006 and the specific urban,*

	administrative and legal context of each region. Section 2.1 of the Community Strategic Guidelines on Cohesion 2007-13 (Council Decision of 6 October 2006 on Community strategic guidelines on cohesion-2006/702/EC- OJ L291 of 21.10.2006) is helpful in this respect. It specifies that "the preparation of a medium- to long-term development plan for sustainable urban development is generally a precondition for success as it ensures the coherence of investments and of their environmental quality. This will also help to secure the commitment and participation of the private sector in urban renewal. In general, a multidisciplinary or integrated approach is needed. For area-based actions, for example, to promote social inclusion, this requires that actions seeking to improve the quality of life (including the environment and housing) or the level of services to citizens are combined with actions to promote the development of new activities and job creation in order to secure the long-term future of the areas concerned. The new JESSICA initiative is designed to promote and facilitate the development of financial engineering products to support projects included in integrated urban development plans. In general, integrated support services and programmes should have a focus on those groups which are most in need, such as immigrants, young people and women. All citizens should be encouraged to participate in both the planning and delivery of services."[i]
Intermediate Body	As defined by Article 2 (6) of the General Regulation, any public or private body or service which acts under the responsibility of a Managing or Certifying Authority, or which carries out duties on behalf of a MA in the deployment of ERDF resources.
Investment Agreement	A legal contract between a Final Recipient and a UDF specifying the rights and obligations of the parties with respect to the UDF investment to be made.
Investment Committee	A committee normally established in accordance with the provisions of a Funding Agreement, entrusted with responsibilities including supervision, guidance and approval of the investment activities managed by the Financial Engineering Instrument.
Investment Period	For the purpose of this document, the duration of time for which UDF Investment Resources are placed with an Urban Project
Investment Recycling	For the purposes of this document, Investment Recycling is an action conducted by the UDF Fund Manager and/or HF Fund Manager, which considers options open to a FEI for the reinvestment of resources in further rounds of investment.
Investment Resources	Please see ‘UDF Investment Resources’
Investment	Referred to in the Implementing regulation and component of the

Strategy	terms and conditions of a Funding Agreement for contributions from Operational Programmes to Financial Engineering Instruments normally including criteria and priorities for the FEI to select investments. In the present document, this refers to both Level I and Level II Funding Agreements. (See also definition of “Business Plan”).
Irregularity (or Irregularities)	Article 2(7) of the General Regulation defines an irregularity as: *“any infringement of a provision of Community Law resulting from an act or omission by an economic operator, which has, or would have, the effect of prejudicing the general budget of the European Union by charging an unjustified item of expenditure to the general budget.”*
JESSICA Evaluation Study	A feasibility assessment for the establishment of financial instruments deploying EU Structural Funds in support of sustainable urban transformation. It should include providing the rationale for the establishment of such financial instruments from a policy, strategic and/or market context, and can highlight both the benefits they can deliver and possible challenges to be overcome.
JESSICA Initiative	A technical assistance initiative developed by the European Commission and the European Investment Bank, in collaboration with the Council of Europe Development Bank, supporting sustainable urban development and regeneration through financial engineering mechanisms. The initiative was launched to assist Member States in considering the option of using some of their Structural Fund allocations to make Repayable Investments in Urban Projects.
JESSICA Operation	Refers to an operation implementing FEIs under Article 44(b) of the General Regulation within a particular Member State or region.
Key Control Framework	A methodology used to conduct a thorough assessment of data submitted within monitoring reports. The framework is intended to reveal additional insights on Urban Project activities that may not be directly apparent through initial reporting.
Level I Funding Agreement	Funding Agreement between a Member State or a Managing Authority and the Holding Fund, where UDFs are organised through Holding Funds.
Level II Funding Agreement	Funding Agreement between a Member State or a Managing Authority (or the Holding Fund where applicable) and a UDF. Currently, the terminology for Level II Funding Agreements most widely used in the market is ‘Operational Agreements’. This is particularly the case when the EIB acts as Holding Fund.
Loan	As defined within COCOF Note 3, a Loan is a type of debt. In a Loan, the borrower initially receives or borrows an amount of money, called the principal, from the lender, and is obligated to pay back or repay an equal amount of money to the lender at a later time. Typically, the money is paid back in regular instalments or partial repayments; in an annuity, each instalment is the same amount. A Loan is generally

	provided at a cost, referred to as interest on the debt.
Major Project	As defined within Article 39 of the General Regulation, a Major Project is an "*Operation (funded by ERDF or the Cohesion Fund) comprising a series of works, activities or services intended in itself to accomplish an indivisible task of a precise economic or technical nature, which has clearly identified goals and whose total cost exceeds EUR 50 million.*"
Managing Authority	In accordance with Article 60 of the General Regulation, a national, regional or local public authority or a public or private body designated by a Member State to manage an Operational Programme.
Management Costs	As defined within Article 78(6) of the General Regulation and Article 43(4) of the Implementing Regulation, Management Costs are the cost of items reimbursed against evidence of expenditure.
Management Fees (of a UDF Fund Manager)	As defined within Article 78(6) of the General Regulation and Article 43(4) of the Implementing Regulation, Management Fees are the agreed price of compensation for services rendered.
Market Economy Investor Principle (MEIP)	The general principle according to which no State Aid is deemed to exist where State resources are applied in a manner which would be acceptable to a private sector investor operating under normal market conditions. MEIP is a key test of whether investment/actions by public authorities involve the provision of State Aid.
Monitoring	Structured and periodic registration of financial and physical information about an Operational Programme, including investments in Urban Projects. The aim of monitoring is to collect and verify the progress of JESSICA Operations and identify any risks to achieving programme objectives.
Monitoring Committee (Also referred to as Programme Monitoring Committee)	As defined in Article 63 of the General Regulation, the monitoring Committee is appointed by the Member State and is responsible for providing supervising assistance on Structural Funds and carrying out monitoring activities. This includes checking how programmes are being managed by the Managing Authority, ensuring compliance with guidelines, implementing rules and reviewing evaluations.
National Co-Financing	National resources (sometimes referred to as "match funding" or "National Contribution") that can be either from the public or private sector, providing the share of OP resources required to complement the contribution from the Structural Funds.
Negotiated Procedure	A public procurement where the purchaser of services may select one or more potential bidders with whom they will then negotiate with respect to the contract. An advertisement in the OJEU is usually required but, in certain circumstances, the contract does not have to be advertised in the OJEU. An example is when, for technical or artistic reasons, or because of the protection of exclusive rights, the contract

	can only be carried out by a particular bidder.
National Strategic Reference Framework (NRSF)	The NRSF 2007–2013 constitutes the reference document for the programming of European Union Funds at national level for the 2007–2013 period. The NRSF is elaborated within the framework of the 2007-2013 strategic approach to the Cohesion Policy of the European Union, according to which NSRF *"…ensures that the assistance from the Funds is consistent with the Community strategic guidelines on cohesion and identifies the link between Community priorities, on the one hand, and the national reform programme, on the other."*
OJEU	The Official Journal of the European Union is the publication in which all tenders from the public sector which are valued above a certain EU-defined financial threshold must be published. Broadly speaking , the legislation covers organisations and projects that receive public money
Open Procedure	A type of public procurement procedure that provides all those interested in the matter/contract advertised in the OJEU with the opportunity to respond to the advertisement by tendering for the contract.
Operation(s)	Article 2 (3) of the General Regulation defines an Operation as "*a project or group of projects selected by a Managing Authority ... allowing achievement of the goals of the priority axis to which it (the project/s) relates.*" Section 1.2 a) of COCOF Note 3 clarifies further the definition of the term 'Operation' stating that "*…in respect of assistance implemented through Financial Engineering Instrument, the operation is constituted by the financial contributions from an operational programme to Financial Engineering Instrument (including holding funds) and the subsequent investments made by the Financial Engineering Instrument, which ultimately constitute eligible expenditure in accordance with Article 78(6) of the General Regulation.*"
Operational Agreement	See 'Level II Funding Agreement'
Operational Programme (OP)	Operational Programmes are programming documents setting out expenditure priorities and development strategies, submitted by the Member States and adopted by the European Commission, covering the use of EU Structural Funds and National Co-financing contributions during the 2007-2013 programming period in the context of the applicable National Strategic Reference Framework.
Priority Axis	A Priority Axis is one of several areas of focus defined within an Operational Programme which serves to guide the direction of the programme. Examples of Priority Axes are 'Stimulating Innovation and Research,' 'Stimulating Enterprise Development,' and 'Achieving Sustainable Urban Development.'

OP resources	ERDF resources and National Contribution are together known as OP resources.
Pari Passu	An investment arrangement where public and private investors share exactly the same upside and downside risks and rewards and hold the same level of subordination, and normally where at least 50 per cent of the funding of the measure is provided by private investors, which are independent from the companies in which they invest (Article 3.2 of the Community guidelines on State Aid to promote risk capital investments in small and medium-sized enterprises)
PEP and Blacklist Testing	Control Measures which could potentially be used as a part of the Key Control Framework (*see "Key Control Framework"*) to identify beneficiaries, management, employees or subcontractors within Urban Projects which may be listed or blacklisted on portals such as World Compliance and present reputational or material risk of inappropriate use of OP resources. PEP refers to the term "Politically Exposed Persons" used in this document to define individuals who hold, or have connections to, positions of political influence.
PQQ	Abbreviation for Pre-Qualification Questionnaire, which is typically used in public procurement processes.
(Urban) Project Sanity Checks	A statistical measure which could potentially be used as a part of the Key Control Framework (*see "Key Control Framework"*) to identify Urban Projects or Urban Project expenses with unusual characteristics.
Programme Secretariat	For the purposed of this document, a body established by the MA to help them, the Monitoring Committee and (where appropriate) the Audit Authority carry out their respective duties. Tasks performed by the secretariat include the collection and registration of all relevant programme information, including possibly on specific Urban Projects, facilitating follow up activities to ensure compliance with regulations, scheduling site visits, and ultimately drafting reports which Managing Authorities need to submit to the Commission.
Progress Report	For the purpose of this document, a report outlining the progress of the OP and/or Urban Project investments. Typically, such a report would be developed in accordance with the reporting procedures laid down in Funding Agreements.
Public Contract	A Public Contract sets out in detail the terms of service or agreement between a government entity and other public/private entity. A Public Contract for the purposes of this document needs to fall within the definition outlined within Article 44 of the General Regulation.
Public-Private Partnership (PPP)	According to the EC Communication on PPPs (COM(2009)615, 19.11.2009), PPPs are forms of cooperation between public authorities and the private sector that aim to modernise the delivery of infrastructure and strategic public services. In some cases, PPPs involve the financing, design, construction, renovation, management or

	maintenance of an infrastructure asset; in others, they incorporate the provision of a service traditionally delivered by public institutions. Whilst the principal focus of PPPs should be on promoting efficiency in public services through risk sharing and harnessing private sector expertise, they can also relieve the immediate pressure on public finances by providing an additional source of capital. In turn, public sector participation in a project may offer important safeguards for private investors, in particular the stability of long term cash-flows from public finances, and can incorporate important social or environmental benefits into a project.
Ratio Analysis	A way of conducting a quantitative analysis of financial data, typically based on financial statements. The analysis can provide a form of investment valuation and/or risk analysis based on a variety of ratios measuring the relationship between key items on the balance sheet and income statement. It could potentially be used as a part of the Key Control Framework (see "Key Control Framework") which identifies Urban Projects for which the distribution of costs amongst the various cost categories deviates from the average distributions within their peer group.
Reference Rate	The interest rate, as calculated in accordance with the methodology contained within the Communication from the Commission on the revision of the method for setting the reference and discount rates (OJ C 14. 19.1.2008, p.6-9), to be applied as a proxy for the market rate in order to measure the grant equivalent of aid, including the case of interest subsidy schemes.
Regional Competitiveness and Employment Objective	One of three regional policy objectives of the EU which aims at strengthening competitiveness and attractiveness of areas outside the Convergence regions (see "Convergence Objective"). This includes helping regions anticipate and promote economic change through innovation and the promotion of the knowledge society, entrepreneurship, the protection of the environment, and the improvement of accessibility.
Repayable Investment	As defined within COCOF Note 3 repayable investments are repayable financial assistance or support wholly or partially financed through Structural Funds' programmes, to address Cohesion policy objectives, by way of Loans, Guarantee s or Equity.
Reporting	The development of documentation and procedures that detail and summarise data collected during monitoring and auditing activities.
Reserve Account	A type of UDF bank account that holds Capital Receipts and Income Receipts received from Urban Projects.
Receipts	Please see refer to the definitions of Income Receipts and Capital Receipts.

Restricted Procedure	A procedure for public procurement that begins with the issuing of a Pre-Qualification Questionnaire (PQQ) through which to pre-select a set of eligible applicants to submit a tender for the contract advertised in the OJEU. The benefit of this approach is that it avoids the need to manage a large number of tenders.
Risk Assessment	Risk Assessment is a step in a risk management procedure and relates to the determination of the quantitative or qualitative value of the credit risk ("valuation"). Quantitative credit risk assessment will require the estimation and calculation of risk (including "expected loss" and "unexpected loss"): the magnitude of the potential loss and the probability that the loss will occur. Risk Assessment involves, for example, undertaking a valuation of risk assessment conditions when deciding to set up guarantees or guarantee funds with Structural Funds' financing under Art 44 of the General Regulation.
Sale of Land Guidelines	Commission Communication on State Aid elements in sales of land and buildings by public authorities, OJ C 209, 10.7.1997, p. 3–5.
Second Level Controls	On-going/ routine administrative checks by the Managing Authority or the Programme Secretariat of Urban Project information, Progress Reports and payment claims. Includes site visits to Urban Projects for a basic check of operations and systems.
State Aid	State Aid refers to forms of assistance from a public body, or publicly-funded body, given to undertakings on a discretionary basis, with the potential to distort competition and affect trade between Member States of the European Union. Also see definition of Market Economy Investor Principle
State Aid for Risk Capital	SARC – Community Guidelines on State Aid to promote risk capital investments in small and medium-sized enterprises OJ C 194, 18.8.2006
Structural Funds	The European Regional Development Fund (“ERDF”) and the European Social Fund (“ESF”) referred to under the General Regulation and Regulations (EC) No. 1080/2006 and 1081/2006 (as amended).
Systems Checks	Conducted by the Audit Authority, this includes an initial check of control systems to certify operations during UDF set-up (a Compliance Assessment) and an annual check to develop the Annual Control Report required from the MA.
Treasury Management	For the purposes of this document, this is the activity performed by the UDF Fund Manager when the UDF contains Idle Resources.
Treaty on the Functioning of the European Union (TFEU)	Formerly known as the Commission Treaty, the Treaty of Rome or the Treaty establishing the European Community. The TFEU was given its name and amended by the Lisbon Treaty. The TFEU sets out organisational and functional details of the European Union.

UDF Investment Resources	The term applied to the full amount of resources available to the UDF to invest in an Urban Project, namely OP resources, plus any additional Co-Investment, Income or Capital Receipts available to the UDF Fund Manager.
UDF Fund Manager	A Fund Manager of a UDF.
Urban Development Fund (UDF)	A financial instrument established in accordance with Article 44b of the General Regulation as well as Articles 43 and 46 of the Implementing Regulation in order to invest by means of loans and guarantees, or equivalent instruments and by means of equity into Urban Projects.
Urban Project	A PPP or other project included in an Integrated Plan for Sustainable Urban Development.
Winding Up (of a UDF)	A process that entails selling all the assets of a fund, paying off creditors, distributing any remaining assets to the principals, and then dissolving the fund. Essentially, "winding up" is to be understood as "liquidation". (Also see “Exit Strategy”)
Working Capital	Working capital relates to the liquid assets an enterprise has available to build its business, but also a measure of its efficiency and financial health. Working capital can be positive or negative, depending on how much short-term debt the company is carrying. A negative working capital means that a company currently is unable to meet its short-term liabilities with cash, accounts receivable, and inventory. Working capital is calculated as Current assets minus current liabilities.

7. LIST OF ABBREVIATIONS

Acronym	Description
CEB	Council of Europe Development Bank
COCOF	Committee for the Coordination of the Funds
COSO	Committee of Sponsoring Organisation
DG REGIO	European Commission's Directorate General for Regional Policy
EAFRD	European Agricultural Fund for Rural Development
EC	European Commission
EEA	European Economic Area
EIB	European Investment Bank
EFF	European Fisheries Fund
EoI	Expression of Interest
ERDF	European Regional Development Fund
ERR	Economic/External Rate of Return
ESF	European Social Fund
EU	European Union
FRR	Fair Rate of Return
IRR	Internal Rate of Return
FA	Funding Agreement (e.g. between MA and HF)
GBER	General Block Exemption Regulation
HF	JESSICA Holding Fund
IC	Investment Committee
IOG	Investment Operating Guideline
IPSUD	Integrated Plan for Sustainable Urban

	Development
JESSICA	Joint European Support for Sustainable Investment in City Areas
MA	Managing Authority
MEIP	Market Economy Investor Principle
MoU	Memorandum of Understanding
MS	Member State
NRSF	National Strategic Reference Framework
OLAF	European Anti-Fraud Office
OP	Operational Programme
PIVT	Project Inspection and Verification Team
PPP	Public Private Partnership
RM	Risk Management
SME	Small and Medium Enterprises
SPV	Special Purpose Vehicle
TFEU	Treaty on the Function of the European Union
UDF	Urban Development Fund

[i] COCOF Guidance 08-0002-03